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IN THE

Supreme Court of the United States

October Term, 1994

STATE OF NEW YORK, *ET AL.*,
Petitioners,

MARYLAND PEOPLE'S COUNSEL, *ET AL.*,
Petitioners-Intervenors,

vs.

FEDERAL COMMUNICATIONS COMMISSION, *ET AL.*,
Respondents,

VOICE-TEL ENTERPRISES, INC., *ET AL.*,
Respondents-Intervenors.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

APPENDIX TO PETITION FOR WRIT OF CERTIORARI

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APPENDIX

OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

(Filed October 18, 1994)

FOR PUBLICATION

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

THE PEOPLE OF THE STATE OF CALIFORNIA, ET AL.,
Petitioners,

PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA, ET AL.,
Petitioners-Intervenors,

v.

FEDERAL COMMUNICATIONS COMMISSION, ET AL.,
Respondents,

BELLSOUTH CORPORATION, ET AL.,
Respondents-Intervenors.

No. 92-70083

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OCT 21 1994
PUBLIC SERVICE COMMISSION
OFFICE OF COUNSEL

MCI COMMUNICATIONS CORPORATION,
Petitioner,

MARYLAND PEOPLE'S COUNSEL, ET AL.,
Petitioners-Intervenors,

v.

FEDERAL COMMUNICATIONS COMMISSION, ET AL.,
Respondents,

VOICE-TEL ENTERPRISES, INC., ET AL.,
Respondents-Intervenors.

No. 92-70186

STATE OF NEW YORK, ET AL.,
Petitioners,

MARYLAND PEOPLE'S COUNSEL, ET AL.,
Petitioners-Intervenors,

v.

FEDERAL COMMUNICATIONS COMMISSION, ET AL.,
Respondents,

VOICE-TEL ENTERPRISES, INC., ET AL.,
Respondents-Intervenors.

No. 92-70217

AMERICAN NEWSPAPER PUBLISHERS ASSOCIATION ("ANPA"), ET AL.,
Petitioners,

BELLSOUTH CORPORATION, ET AL.,
Intervenors,

v.

FEDERAL COMMUNICATIONS COMMISSION, ET AL.,
Respondents.

No. 92-70261

OPINION

Appeal from an Order of the
Federal Communications Commission

Argued and Submitted
April 11, 1994—San Francisco, California

Filed October 18, 1994

Before: Mary M. Schroeder, Dorothy W. Nelson, and William C. Canby, Jr., Circuit Judges.

Opinion by Judge Schroeder

SUMMARY

Government Law/Communications/Administrative Law

The court of appeals granted a petition for review of an order of the Federal Communications Commission (FCC), vacated in part an FCC order, and remanded to the FCC. The court held that part of an FCC order is arbitrary and capricious due to the FCC's failure to explain or justify its change in policy regarding nonstructural safeguards against Regional Bell Operating Companies' (BOCs') discriminating in favor of their own enhanced services in providing access to telephone transmission facilities.

Certain FCC orders, known as *Computer III* specified the conditions under which the BOCs could provide enhanced computerized data services to their customers in addition to providing basic telephone service. *Computer III* eliminated earlier requirements that the BOCs maintain separate corporate structures for the provision of enhanced services. Because state regulations had also required structural separation, *Computer III* also ordered that such state requirements be preempted by the federal directive.

In *California v. FCC* (*California I*), the court of appeals remanded for reconsideration of the *Computer III* orders. The court remanded for the FCC to reconsider certain aspects of the cost benefit analysis underlying the elimination of structural separation. The court also directed the FCC to reconsider its preemption order in light of the Federal Communications Act requirement that preemption be narrowly tailored to promote dual, state and federal, regulatory goals.

In the order issued on remand, *Computer III Remand Proceedings Order* (*Order on Remand*), the FCC once again eliminated structural separation requirements, but imposed strengthened nonstructural safeguards intended to address the concerns the court of appeals expressed in *California I*. The FCC also modified its preemption order so that it no longer purported to preempt all state structural separation requirements, but only those affecting services that include both interstate and intrastate communications.

After *California I*, but before the entry of the *Order on Remand*, petitioners the people of the State of California, the Public Service Commission of the District of Columbia, MCI Communications Corp., the Maryland People's Counsel, the State of New York, and the American Newspaper Publishers Association, attacked a related series of FCC orders. The court of appeals reviewed the orders in *California II*, and found that the orders amounted to a retreat from the policy announced in *Computer III* of achieving the concept known as open network architecture (ONA) as a precondition to structural separation. The court held, however, that the change in policy itself did not violate the Administrative Procedures Act (APA), because it was adequately explained by the technological inability to achieve complete ONA.

Petitioners who are competitors of the BOCs in providing enhanced services to telephone customers (collectively, MCI) petitioned for review of the FCC order, challenging the FCC's cost benefit analysis in eliminating structural separation. They contended that the nonstructural safeguards are inadequate to prevent anti-competitive behavior by the BOCs. A second set of petitioners, represented by the States of California and New York, challenged the modified preemption aspects of the *Order on Remand*.

[1] On remand, the FCC established additional regulatory safeguards designed to reduce cross-subsidization; [2] the FCC adopted mandatory price cap regulation for the BOCs

and established new cost accounting rules that would make cross-subsidization easier to detect. [3] With the implementation of these measures, the FCC responded to the Ninth Circuit's concerns about the weakness of its position in *Computer III* and demonstrated that the BOCs' incentive and ability to cross-subsidize will be significantly reduced.

[4] In *California II*, the Ninth Circuit held that the FCC's ONA orders, now integrated into the *Order on Remand*, represented a change in policy from ONA as envisioned in *Computer III*. [5] The FCC, in the *Order on Remand*, as in its orders implementing ONA, has changed its requirements for, or definition of, ONA so that ONA no longer contemplates fundamental unbundling. Yet, in *Computer III*, the FCC regarded fundamental unbundling as a key safeguard against access discrimination. In the *Order on Remand*, the FCC never explained why it now authorizes lifting structural separation when it recognizes that its assumptions in *Computer III* regarding ONA have not proven correct, and that fundamental unbundling is not attainable at this time. Now that fundamental unbundling is no longer regarded as attainable, the FCC should have adjusted its cost benefit analysis accordingly. It did not do so. [6] Because the FCC's cost benefit analysis was flawed, the *Order on Remand* was set aside as arbitrary and capricious under the APA.

[7] MCI also challenged a provision in the *Order on Remand* that deals with Customer Proprietary Network Information (CPNI). [8] However, the new CPNI rules set forth in the order were not arbitrary and capricious.

[9] The FCC has presented adequate record support for its conclusion that because of economic and operational factors, enhanced service providers would separate their facilities for services that are offered both interstate and intrastate, thereby essentially negating the FCC's goal of allowing integrated provision of enhanced and basic services. [10] Thus, the

FCC's preemption of state structural separation requirements was authorized in this case.

[11] The FCC's preemption of state regulations regarding CPNI and network disclosure rules was also affirmed. [12] The FCC met its burden of showing that its regulatory goals of authorizing integration of services would be negated by the state regulations it preempted. Thus, the preemption aspects of the *Order on Remand* were upheld.

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OPINION

SCHROEDER, Circuit Judge:

I. INTRODUCTION

We review the order that the Federal Communications Commission entered as a result of our decision in *California v. FCC*, 905 F.2d 1217 (9th Cir. 1990) (*California I*). In that case, we remanded for reconsideration certain FCC orders, known as *Computer III*,[1] that specified the conditions under

[1]Report and Order, *In re Amendment of Sections 64.702 of the Commission's Rules and Regulations (Third Computer Inquiry)*, (Docket No. 85-229), 104 F.C.C.2d 958 (1986) (*Computer III*), *on reconsideration*, 2 F.C.C.R. 3035 (1987); 2 F.C.C.R. 3072 (1987); Memorandum Opinion and Order on Further Reconsideration, *In re Amendment of Sections 64.702 of the Commission's Rules and Regulations (Third Computer Inquiry)*, 3 F.C.C.R. 1135 (1988); Memorandum Opinion and Order on Reconsideration, *In re Amendment of Sections 64.702 of the Commission's Rules and Regulations (Third Computer Inquiry)*, 3 F.C.C.R. 1150 (1988).

which the Regional Bell Operating Companies (BOCs) could provide enhanced computerized data services to their customers in addition to providing basic telephone service. *Computer III* eliminated earlier requirements that the BOCs maintain separate corporate structures for the provision of enhanced services. Because state regulations had also required structural separation, *Computer III* also ordered that such state requirements be preempted by the federal directive.

In *California I* we remanded for the FCC to reconsider certain aspects of the cost benefit analysis underlying the elimination of structural separation. We also directed the FCC to reconsider its preemption order in light of the Federal Communications Act requirement that preemption be narrowly tailored to promote dual, state and federal, regulatory goals.

In the order issued on remand, *Computer III Remand Proceedings Order*,[2] the FCC once again eliminated structural separation requirements, but imposed strengthened nonstructural safeguards intended to address the concerns we expressed in *California I*. The FCC also modified its preemption order so that it no longer purported to preempt all state structural separation requirements, but only those affecting services that include both interstate and intrastate communications.

After *California I*, but before the entry of the *Computer III Remand Proceedings Order*, (hereafter *Order on Remand*), petitioners in this proceeding also attacked a related series of FCC orders.[3] We reviewed those orders in

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[2]Report and Order, *In the Matter of Computer III Remand Proceedings: Bell Operating Company Safeguards and Tier 1 Local Exchange Company Safeguards*, CC Docket 90-623, 6 F.C.C.R. 7571 (1991).

[3]Memorandum Opinion and Order, *Filing and Review of Open Network Architecture Plans*, Phase I, FCC 88-381, 4 F.C.C.R. 1 (1988); Memorandum Opinion and Order on Reconsideration, *Filing and Review of Open Network Architecture Plans*, Phase I, FCC 90-134, 5 F.C.C.R. 3084 (1990); Memorandum Opinion and Order, *Filing and Review of Open Network Architecture Plans*, Phase I, FCC 90-135, 5 F.C.C.R. 3103 (1990); and Report and Order, *Computer III Remand Proceedings*, FCC 90-415, 5 F.C.C.R. 7719 (1990).

California v. FCC, 4 F.3d 1505 (9th Cir. 1993) (*California II*). We agreed with petitioners in that case that the orders under consideration amounted to a retreat from the policy announced in *Computer III* of achieving the concept known as open network architecture (ONA) as a precondition to structural separation. *Id.* at 1512. We held that ONA as envisioned in *Computer III* would have provided all enhanced service providers equal access to the components of the BOCs' telephonic network. We held, however, that the change in policy itself did not violate the Administrative Procedures Act, because it was adequately explained by the technological inability to achieve complete ONA. *Id.* at 1513.

At the time we were considering *California II*, the Commission had already entered the *Order on Remand*, but petitions for review of that decision had not yet been briefed. We therefore declined to decide whether the ONA policy change had an effect on the validity of the FCC's decision to eliminate structural separation. We held that all such issues should await our consideration of this order. *Id.*

Petitioners in this case are the same as petitioners in *California I* and *California II*, and are divided into two sets. The first, described collectively as MCI,[4] are competitors of the BOCs in providing enhanced services to telephone customers. They once again challenge the FCC's cost benefit analysis in eliminating structural separation, contending that the nonstructural safeguards are inadequate to prevent anti-

[4]Petitioners are MCI Telecommunications Corporation and Newspaper Association of America. The following parties are intervenors in support of MCI: Compuserve, Inc., Information Technology Association of America, Information Industry Association, Pennsylvania Office of Consumer Advocate, and Maryland People's Counsel.

The following parties are intervenors in support of FCC on the MCI petitions: Illinois Bell, Indiana Bell, Michigan Bell, Ohio Bell, Wisconsin Bell, Bell Atlantic, BellSouth, Pacific Bell, Nevada Bell, Southwestern Bell, U.S. West Communications, Bell Operating Companies, United States Telephone Association, and NYNEX.

competitive behavior by the BOCs. The second set of petitioners, represented by the States of California and New York,[6] challenge the modified preemption aspects of the *Order on Remand.*

We first consider MCI's petition challenging the elimination of structural separation. We hold that the FCC adequately responded to the concerns we expressed in *California I* by increasing the nonstructural safeguards designed to prevent the BOCs from passing on the costs of their enhanced services to their telephone customers paying regulated rates. We further hold, however, that the FCC's overall cost benefit analysis remains flawed. In *Computer III*, the FCC concluded that full ONA would be necessary to ensure fair competition between the BOCs and MCI in the absence of structural separation. We held in *California II* that the FCC had retreated from its position that full ONA was a prerequisite for eliminating structural separation to ensure access to the BOCs' networks. The *Order on Remand* does not take this change into account. Therefore, once again we remand for reconsideration of the cost benefit analysis with respect to structural separation.

In the California and New York petitions, we hold that the FCC has adequately addressed the concerns we raised in *California I*. We therefore affirm the preemption aspects of the FCC's *Order on Remand.*

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[6]The following parties are intervenors in support of California and New York: Florida Public Service Commission, Maryland People's Counsel, Pennsylvania Office of Consumer Advocate, Pennsylvania Public Utility Commission, and National Association of Regulatory Utility Commissioners.

The following parties are intervenors in support of FCC on the California and New York petitions: International Business Machines Corporation, American Telephone & Telegraph Company, Bell Atlantic, BellSouth, NYNEX, Pacific Bell, Nevada Bell, Southwestern Bell, U.S. West Communications, Information Industry Association, and Information Technology Association of America.

II. STRUCTURAL SEPARATION

Background

In this case we deal with the "enhanced services industry" that in three decades has transformed the telephone lines into an information super highway. Enhanced services use computerized data processing to bring an ever expanding variety of information to users over the telephone communications network. That network is controlled by the Regional Bell Operating Companies that maintain monopolies over local telephone service that are regulated by the Federal Communications Commission.

From the inception of the enhanced services industry, the FCC has declined to regulate it in the interest of promoting competition among providers of enhanced services.[6] The FCC was concerned, however, that the telephone industry could use its monopoly of the lines to prevent competition from developing in the enhanced services industry. It sought to prevent the telephone carriers, which were eager to enter the enhanced services industry, from exploiting their monopoly over the telephone lines to obtain an unfair advantage. Therefore, in its Second Computer Inquiry,[7] the FCC in 1980 ordered that AT&T and its local exchange affiliates at that time, the Bell operating companies, form separate companies to provide enhanced services, companies that would have complete structural separation from the companies that provided basic telephone service. After the breakup of AT&T and the divestment of the Regional Bell Operating Companies, the FCC ordered that the BOCs maintain structural sepa-

[6]The history of the FCC's regulation of the enhanced services industry is set forth more fully in our opinion in *California I*, 905 F.2d at 1223-30.

[7]Final Decision, *In re Amendment of Section 64.702 of the Commission's Rules and Regulations (Second Computer Inquiry)*, 77 F.C.C.2d 384 (1980) (*Computer II*).

ration between their basic telephone operations and subsidiary entities providing enhanced services.[8]

The FCC adopted structural separation to prevent two problems. First, the FCC was concerned that the BOCs would gain an unfair competitive edge in the enhanced services industry by discriminating in favor of their own enhanced services in providing access to the telephone transmission facilities. Second, the FCC sought to prevent the BOCs from exploiting their monopolies over the telephone industry by cross-subsidization: passing on the costs of their enhanced services to regular telephone ratepayers who are required to use the carriers because of their monopoly over local phone services. These concerns are more fully discussed in *California I*. *See* 905 F.2d at 1224.

The structural separation requirement imposed by *Computer II* required the BOCs to produce and market enhanced services independent of their basic telephone services. Accordingly, the BOCs' enhanced service subsidiaries were required to maintain separate physical facilities, separate personnel, and different accounting records. The FCC determined that structural separation would make it difficult for the BOCs to cross-subsidize and that it would reduce the chance of access discrimination by putting the BOCs' enhanced service subsidiaries on equal footing with independent enhanced service providers when seeking transmission services.

In 1986, the FCC issued its *Computer III* decision in which it changed its position and ordered that structural separation requirements be eliminated. As we summarized in *California II*,

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[8]Report and Order, *In re Policy and Rules Concerning the Furnishing of Customer Premises Equipment, Enhanced Services and Cellular Communications Services by the Bell Operating Companies*, 95 F.C.C.2d 1117 (1983), *aff'd sub nom. Illinois Bell Tel. Co. v. FCC*, 740 F.2d 465 (7th Cir. 1984).

> The FCC reasoned that the BOCs' divestiture from AT & T and increased market competition had diminished the value of structural separation as a safeguard against monopoly abuse. Moreover, the FCC concluded that the costs of structural separation exceeded its public benefits. Nevertheless, because the FCC found that the BOCs continued to have monopoly power over access to the telephone transmission facilities, the FCC proposed to replace the structural separation requirements with non-structural regulations.

4 F.3d at 1508.

In *California I* we reviewed MCI's challenge to *Computer III*. We summarized petitioners' claims as follows:

> Petitioners claim that it was irrational for the FCC to abandon structural safeguards so soon after imposing them on AT & T in *Computer II* and reimposing them on the divested BOCs . . . . Structural safeguards, argue petitioners, have been the Commission's primary weapon for preventing anticompetitive conduct such as cross-subsidization and discriminatory access, and these safeguards . . . are a long-standing FCC rule which was abandoned without a reasoned agency decision.

905 F.2d at 1230.

In *California I* we first determined that the FCC could reasonably have concluded on the record before it that structural separation impeded the development and marketing of some new forms of enhanced services. *Id.* at 1232. We found that the FCC had made a "plausible case" that lifting the structural separation requirement would benefit consumers by permitting the BOCs to operate more efficiently in the enhanced services market. *Id.* at 1238.

Second, we concluded that the FCC had also made a "plausible case" that nonstructural safeguards based on the development of new technology, including open network architecture (ONA) and comparably efficient interconnection (CEI), would effectively reduce the risk of BOC access discrimination once the structural separation requirement was lifted. *Id.* at 1233, 1238.

Third, we found that the record did not support the FCC's conclusion that market and technological changes had reduced the danger of cross-subsidization. *Id.* at 1233-38. Accordingly, we held that it was arbitrary and capricious for the FCC to replace structural separation with cost accounting regulations to protect against the harmful effects of cross-subsidization. *Id.* at 1238. We vacated the orders and remanded. However, the FCC entered an order granting waivers of the structural separation requirements; consequently, the BOCs have continued to provide enhanced services on an integrated basis.

In this petition, we must again review the FCC's weighing of the costs and benefits of structural separation.

Standard of Review

Section 10(e) of the Administrative Procedures Act requires a reviewing court to set aside agency action if it is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C § 706(2)(A). We must "determine whether the [FCC's] decision was a reasonable exercise of its discretion, based on consideration of relevant factors, and supported by the record." *California I*, 905 F.2d at 1230. The scope of judicial review under this standard is narrow and an agency's interpretation of its own policies and prior orders is entitled to deference. *Id.* Nevertheless, although the standard of review is deferential, it may not be uncritical. *Id.* We therefore may require the agency to provide a reasoned analysis indicating that prior policies and standards

are being deliberately changed, not casually ignored. *Motor Vehicle Mfrs. Ass'n v. State Farm Mutual Auto Ins. Co.*, 463 U.S. 29, 43-44 (1983) (*State Farm*); *Office of Communication of United Church of Christ v. FCC*, 707 F.2d 1413, 1425 (D.C. Cir. 1983). Moreover, if the record reveals that the agency has " 'failed to consider an important aspect of the problem' or has 'offered an explanation for its decision that runs counter to the evidence before [it],' " we must find the agency in violation of the APA. *California I*, 905 F.2d at 1230 (quoting *State Farm*, 463 U.S. at 43).

Costs of Structural Separation: The Value of Voice Mail

The principal costs of structural separation in the eyes of the FCC have been the discouragement of innovation, the prevention of efficiency in the packages of services offered consumers, and the duplication of organizations and facilities. One example of discouragement of innovation has been the prevention of the development of the voicemail market for small customers. MCI contends that the FCC placed too much emphasis on the BOCs as the only potential source of mass market enhanced services and ignored the impact of anticompetitive behavior of the BOCs in preventing competitors from offering enhanced services. MCI further contends that the FCC overemphasized the importance of voice mail, which represents only one in a large array of enhanced services. In *California I*, we were less than laudatory in our assessment of the FCC's analysis of the costs of structural separation and expressed concern that the only concrete example the FCC used to support its cost analysis was voice mail. 905 F.2d at 1232. Nevertheless, we recognized that it was not arbitrary or capricious for the FCC to determine that the inability of the BOCs to develop this market is a substantial cost of structural separation. *See id.* Petitioners have not raised any new claims with regard to the FCC's analysis of the costs of structural separation which would require us to reconsider our conclusion in *California I*. Accordingly, we turn to the FCC's response to our concerns about cross-subsidization.

The Adequacy of the FCC's Response to California I's Decision on Cross-Subsidization

[1] Because the inadequacies of *Computer III* upon which we focused in *California I* dealt with the nonstructural measures relating to cross-subsidization, the FCC on remand directed its primary attention to strengthening the protections against cross-subsidization. On remand, the FCC established additional regulatory safeguards designed to reduce cross-subsidization.

[2] First, the FCC adopted mandatory price cap regulation for the BOCs. Under price caps, a BOC's rates are governed by factors outside of its control, such as the inflation index, rather than by direct costs. Thus, a BOC would have little incentive to shift costs from nonregulated activities to regulated ones because it would not be able to increase regulated rates to recapture those costs. Second, the FCC established new cost accounting rules that would make cross-subsidization easier to detect. These rules included (1) joint cost rules, which provide that nonregulated enhanced services must contribute to overhead costs of regulated BOC operations, (2) cost allocation manuals, (3) annual audits by independent auditors, in which the auditor must evaluate whether the company's financial statements conform with generally accepted accounting principles, (4) reporting requirements under a new, uniform, detailed, computerized system known as the Automated Reporting and Management Information System, and (5) on-site audits conducted by FCC staff.

MCI argues that the FCC failed to provide record evidence to demonstrate the effectiveness of the accounting safeguards. The FCC counters that price cap regulation and the strengthened cost accounting rules, all of which were adopted after *Computer III*, are sufficient to reduce the danger of cross-subsidization. In addition, the FCC argues that regulators can use the seven BOCs as benchmarks against each other in detecting improper cost-shifting. The FCC acknowledges that

it is making a predictive judgment that these measures will be effective, but argues that it is within its authority as a regulatory agency to do so and that it has supported its judgment with reasoned analysis and due consideration of the record.

[3] In *California I*, we concluded that the FCC had unreasonably reversed, without adequate explanation, its previous position that cost-accounting regulations alone would fail to guard against cross-subsidization. *See California I*, 905 F.2d at 1233. We recognized that changes in the telecommunications market, such as development of competing cable and microwave communication systems, could reduce incentives to cross-subsidize. Nonetheless, we rejected the FCC's reliance on changes in the telecommunications market to reduce the danger of cross-subsidization. *See id.* at 1233-38. On remand, the FCC has taken specific affirmative steps designed to deter and detect cross-subsidization by introducing price caps as well as further strengthening its cost accounting rules. We conclude that with the implementation of these measures, the FCC has responded to our concerns about the weakness of its position in *Computer III* and has demonstrated that the BOCs' incentive and ability to cross-subsidize will be significantly reduced. That the efficacy of these measures has yet to be proven is not in and of itself a basis for finding the FCC's decision arbitrary and capricious. *See, e.g., American Postal Workers Union v. United States Postal Serv.*, 891 F.2d 304, 314 (D.C. Cir. 1989) (noting that "agencies are entitled to engage in predictive judgments" and that " 'complete factual support' is not required where such predictions 'necessarily involve[ ] deductions based on the expert knowledge of the agency' " (quoting *FCC v. National Citizens Comm. for Broadcasting*, 436 U.S. 775, 814 (1978))).

Our conclusion is bolstered by the intervening decision of the D.C. Circuit that considered whether the FCC's new regulations would reduce the danger of cross-subsidization. *United States v. Western Elec. Co.*, 993 F.2d 1572 (D.C. Cir.), *cert. denied*, 114 S. Ct. 487 (1993). The D.C. Circuit concluded

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that price cap regulation "reduces any BOC's ability to shift costs from unregulated to regulated activities, because the increase in costs for the regulated activity does not automatically cause an increase in the legal rate ceiling." *Id.* at 1580. The court also found that the FCC had "tighten[ed] its accounting rules, especially its treatment of joint costs, all tending to increase the chances of catching any attempts at cost-shifting," *id.* at 1580-81, and that regulators and competitors could use the seven BOCs as benchmarks against each other to detect predatory pricing, *id.* at 1580. Finally, the court found that pressure on the BOCs to keep residential service rates low undermined the theory of regulatory capture on which successful cross-subsidization depends. *Id.* at 1581.

The Implementation of ONA after Computer III

[4] Our review of the validity of the FCC's *Order on Remand* eliminating structural separation requirements has begun with our determination that the FCC has now adequately strengthened the protections against cross-subsidization and therefore has addressed the concerns expressed by this court in *California I*. Our review of this order cannot end with that determination, however. In entering the *Order on Remand*, the FCC was acting not only on the basis of our decision in *California I* but also in the wake of its additional orders regarding open network architecture, ONA. We held in *California II* that the FCC's ONA orders, now integrated into the *Order on Remand*, represented a change in policy from ONA as envisioned in *Computer III*. MCI now contends the changed policy undermines the validity of this order eliminating structural separation because, in light of the policy change, there are no longer adequate safeguards against discrimination in access. It is to that contention that we now turn.

In *Computer III* the FCC ordered the BOCs to develop plans for ONA that would permit enhanced service providers to achieve maximum flexibility in gaining access to telephone

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transmission facilities thereby allowing them to offer innovative packages of services to consumers. The FCC determined that the open network architecture requirements would be "self-enforcing in controlling discrimination." *Computer III*, 104 F.C.C.2d at 1063.

Computer III anticipated that advances in technology would make it possible to achieve what was termed complete "unbundling" of service components into "building blocks" that would permit the enhanced service providers to construct their own innovative services as easily as the BOCs. The FCC specified that all basic network capabilities that would be useful in enhanced service applications, "including signaling, switching, billing, and network management" would be subject to the unbundling requirement. *Id.* at 1040. The FCC observed that "[s]uch unbundling is essential to give competing enhanced services providers an opportunity to design offerings that utilize network services in a flexible and economical manner. In essence, competitors will pay only for those Basic Service Elements that they use in providing enhanced services." *Id.* at 1064. This unbundling was intended to permit BOCs' enhanced service competitors to purchase only those elements necessary to a specific type of enhanced service. The network was to be open in order to prevent the BOCs from limiting access, and the unbundled elements were to be tariffed in order to prevent overcharges. *See California II*, 905 F.2d at 1509.

As an interim measure, *Computer III* required the BOCs to establish "comparably efficient interconnection" (CEI) plans so that the BOCs could provide integrated enhanced services pending the unbundling of the networks. The BOCs had to file CEI plans for each enhanced service the BOCs offered. The CEI plans ensured that enhanced service competitors were provided with interconnections to the BOCs' own networks that were substantially equivalent to the interconnections that the BOCs provided for their own enhanced services. CEI, in contrast to ONA, was limited to offering the competi-

tors only the interconnections for enhanced services that the BOCs themselves already offered. CEI does not allow competitors to pick and choose building blocks to create their own enhanced services. *See California II*, 905 F.2d at 1511.

In *California I* we accepted the FCC's assessment that, because of ONA, structural separation was no longer required to prevent access discrimination. We observed that the network access policies that the FCC planned to substitute for structural separation depended on the development of new technologies.

> The FCC's policy of Comparably Efficient Interconnection (CEI) is designed to ensure that each BOC will provide competitors with connections to the local exchange that equal the connections available to the BOCs' own enhanced services offerings. Moreover, the Open Network Architecture (ONA) policy requires each BOC to incorporate CEI concepts into the overall design of its basic service network. Thus, the record supports the Commission's finding that technologies for ensuring equal access have improved, and may be effective in preventing discrimination in ways not feasible in the past.

California I, 905 F.2d at 1233.

The BOCs were required to file open network architecture plans by 1988; approval of such plans was a precondition to the removal of structural separation. As the FCC said in *Computer III*:

> After implementation of an approved Open Network Architecture Plan and the carrier's satisfaction of our cost allocation and other safeguards, the structural separation requirements will no longer apply to the carrier's enhanced services operations, and it will not

> be required to file a service-specific CEI plan prior to offering a new enhanced service.

Computer III, 104 F.C.C.2d at 1067-68.

Beginning in 1988, the FCC filed a series of orders reviewing the ONA plans that the BOCs submitted.[9] It is these orders implementing ONA that we reviewed in *California II*. We concluded that they constituted a retreat from the original promise of *Computer III*.

In *California II* we reviewed MCI's claim that, in approving the ONA plans, the FCC had significantly altered, without reasoned justification, the scope and purpose of ONA as articulated in *Computer III*. 4 F.3d at 1510-11. We rejected the FCC's claim that ONA had always been intended to be an evolutionary process. *Id.* at 1511. We agreed with MCI that because the ONA plans as approved did not accomplish fundamental unbundling, the FCC's approval of these plans constituted a change from its position that complete ONA was a prerequisite to the elimination of structural separation. We stated: "[t]he orders before us represent a change from the FCC's earlier view in *Computer III* that complete ONA would precede lifting structural separation. These orders advance the view that structural separation can be lifted before the implementation of a fully realized ONA." *Id.* at 1513. We did not, however, set aside the orders implementing ONA because those orders did not themselves lift structural separation or explain the conditions under which structural separation, after *California I*, could be lifted. The *Order on Remand* does lift structural separation, and we must consider whether it adequately explains why fully implemented ONA is no longer regarded as a necessary safeguard against access discrimination after removal of structural separation.

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[9] *See supra* note 3.

In a companion order to the *Order on Remand*, the FCC conditionally approved ONA plans filed by the BOCs.[10] In this order, as in the ONA orders reviewed in *California II*, the FCC reaffirmed its view that ONA will be an evolutionary process. In line with this policy shift, the approved ONA plans do not offer full deployment of ONA services and are not based on new technology. In the *Order on Remand*, the FCC recognized that it no longer requires fundamental unbundling of the BOC networks as a precondition to lifting structural separation. "[T]he Commission declined to require a radical reconfiguration or fundamental unbundling of the BOC networks, stating that providing ONA based on a more disaggregated and at that time unspecified architecture would be extremely costly and unnecessary for effective implementation of ONA." *Order on Remand*, 6 F.C.C.R. at 7600-01.

In support of its claim that the nonstructural safeguards currently regarded as adequate by the FCC will not prevent access discrimination, MCI argues that the record contains evidence of access discrimination by the BOCs in the provision of enhanced services. MCI relies heavily on the decision of the Georgia Public Service Commission (Georgia PSC) in its investigation into BellSouth's provision of MemoryCall Service. Order of the Commission, *In the Matter of the Commission's Investigation into Southern Bell Telephone and Telegraph Company's Trial Provision of MemoryCall Service*, Docket No. 4000-U (Ga. PSC June 4, 1991). The Georgia PSC authorized BellSouth to provide an intrastate voice-messaging system, known as MemoryCall, to limited markets on a trial basis. After conducting an investigation into the provision of MemoryCall, the Georgia PSC concluded that BellSouth had the opportunity and incentive to behave anticompetitively given its monopoly over the local exchange and had in fact discriminated against competitor enhanced service providers by giving them inferior access to the local

[10] *In the Matter of Filing and Review of Open Network Architecture Plans*, CC Docket No. 88-2, Phase I (1991).

network. The Georgia PSC found that the record demonstrated at least three significant instances of discriminatory behavior by BellSouth. The Georgia PSC found that: (1) because of technical barriers to independent enhanced service providers' use of the local networks, competitors could only provide a voice-messaging service that was significantly inferior to MemoryCall; (2) Bellsouth had refused to allow competitors to co-locate their equipment in BellSouth's central offices, resulting in quality and price disadvantages for competitors; and (3) BellSouth had manipulated development of the local network, especially the timing of the unbundling of certain network features necessary for voice-messaging services, in order to maximize its competitive advantage for its initial offering of MemoryCall. *Id.* at 27-34.

The FCC responds that the MemoryCall case does not show that its safeguards are ineffective because, among other reasons, ONA had not yet been implemented at that time. The problem with this argument is that ONA, at least as defined in *Computer III*, still has not been achieved. The MemoryCall case shows that the BOCs have the incentive to discriminate and the ability to exploit their monopoly control over the local networks to frustrate regulators' attempts to prevent anticompetitive behavior. The FCC has not explained adequately how its diluted version of ONA will prevent this behavior.

The FCC contends that ONA is merely one component of its overall regulatory scheme designed to prevent access discrimination. The FCC points to the other safeguards against access discrimination it has established, including CEI, nondiscrimination reporting requirements and network disclosure rules. The FCC contends that even without fully implemented ONA, these safeguards will prevent access discrimination. The problem with this argument is that the FCC ruled to the contrary in *Computer III* and has not explained, in its *Order on Remand* or elsewhere in its formal rulings, why the conclusion it reached in *Computer III* regarding ONA has changed.

Under CEI, the BOCs must provide other enhanced service providers the same interconnections the BOCs use in providing their own services. The nondiscrimination reporting requirements are designed to allow the FCC to determine whether the BOCs are providing the same quality of service to competitors as used in the BOCs' own enhanced services. The network disclosure rules provide that the BOCs must give notice to competitors of new or modified network services affecting interconnection for enhanced services.

While CEI and the nondiscrimination reporting requirements are designed to prevent BOC discrimination against other enhanced service providers where a BOC is providing its own enhanced service, these safeguards do not enable enhanced service providers to pick and choose network service elements to design and develop enhanced services. Consequently, competitors who otherwise would be able to compete effectively by offering more efficient packages of services had fundamental unbundling been accomplished might be excluded from the market entirely. Further, the network disclosure rules do not guarantee that the BOCs will provide competitors with the interconnection they need for their enhanced services. Thus, according to the analysis of the FCC in *Computer III*, these safeguards are not a substitute for ONA and, without ONA, are not adequate to prevent access discrimination. If there conclusions no longer hold, the FCC has not explained why.

[5] In our view, the FCC in the *Order on Remand*, as in its orders implementing ONA, has changed its requirements for, or definition of, ONA so that ONA no longer contemplates fundamental unbundling. Yet in *Computer III* the FCC regarded that fundamental unbundling as a key safeguard against access discrimination. In the *Order on Remand*, the FCC never explains why it now authorizes lifting structural separation when it recognizes that its assumptions in *Computer III* regarding ONA have not proven correct, and that fundamental unbundling is not attainable at this time. In

Computer III, the FCC concluded that ONA, based on new technology to permit fundamental unbundling, would be a key nonstructural safeguard in preventing access discrimination as effectively as structural separation. Relying on this conclusion, the FCC determined that the benefit of maintaining structural separation to prevent discrimination was minimal. Now that fundamental unbundling is no longer regarded as attainable, the FCC should have adjusted its cost benefit analysis accordingly. It has not done so.

[6] In *California I*, we held that because the FCC had not supported its conclusions regarding prevention of cross-subsidization, the FCC's overall cost benefit analysis was flawed and its order was arbitrary and capricious under the APA. 905 F.2d at 1238. Here, the FCC has similarly failed to provide support or explanation for some of its material conclusions regarding prevention of access discrimination. Thus, once again, we conclude that the FCC's cost benefit analysis is flawed and set aside the *Order on Remand* as arbitrary and capricious under the APA.

Customer Proprietary Network Information

[7] Collateral to its renewed attacks on the FCC's cost benefit analysis, MCI also challenges the provision in the *Order on Remand* that deals with Customer Proprietary Network Information (CPNI).

CPNI is information about a telephone customer's use of the telephone network, such as the number of lines ordered, service location, type and class of services purchased, usage levels, and calling patterns. This information is generated by the BOCs in their provision of basic telecommunications services. CPNI is useful to the BOCs and competitor enhanced service providers in their development and marketing of enhanced services because it can assist them in identifying potential customers, designing more efficient services, and better meeting customer needs. Customers, however, have

proprietary and privacy interests in their CPNI and for this reason may seek to restrict access to their CPNI. *Order on Remand*, 6 F.C.C.R. at 7607, 7611.

In *Computer III*, the FCC adopted rules governing access to CPNI. These rules allowed the BOCs, including BOC enhanced services personnel, unrestricted access to the CPNI of BOC telephone customers unless the customer requested confidentiality. Customers, however, were not notified of their option to request confidentiality, so for the most part the BOCs had unrestricted access to CPNI by default. Independent enhanced service providers, however, were required to obtain prior authorization from customers for access to CPNI.

In the *Order on Remand*, the FCC strengthened the rules governing access to CPNI to protect customer confidentiality and to eliminate, in part, the BOCs' previous advantage. The FCC ordered that for customers with more than 20 lines, both the BOCs and competitors must obtain prior customer authorization for access to CPNI. For small customers, defined as those having 20 lines or less, the rules remain the same. Thus, the BOCs shall have access to CPNI of small customers unless the customer requests confidentiality, but independent enhanced service providers must obtain prior customer authorization before they can obtain CPNI for small customers.

[8] The FCC's strengthened CPNI rules provide more competitive equity to MCI than the previous rules under *Computer III*, which were not challenged in *California I*. It is not clear why the CPNI rules are challenged for the first time in this petition. We conclude that the new CPNI rules set forth in this order are not arbitrary and capricious.

MCI challenges the new rules as irrational, largely because they are "asymmetrical." The new CPNI rules allow MCI to compete with the BOCs on an equal basis with respect to large customers, whose CPNI is more competitively valuable. At the same time, the asymmetric rule for small customers

recognizes that the BOCs are uniquely situated to develop the market for small customers. The FCC found that BOC access to CPNI is justified because it allows customers the benefit of one-stop shopping which is important to the development of a mass market in enhanced services. The FCC found that the BOCs are uniquely positioned to reach small customers, and that it would be economically infeasible to develop a mass market for enhanced services if prior authorization was required for access to CPNI. If small customers are required to take an affirmative step of authorizing access to their information, they are unlikely to exercise this option and thereby impair the development of the mass market for enhanced services in the small customer market.

In adopting the new CPNI rules, the FCC balanced the competing interests of competitive equity, customer privacy, and the need for efficiency in the development of mass market enhanced services. We conclude that the FCC's balancing of these interests was not arbitrary and capricious.

III. PREEMPTION

The Communications Act of 1934, 47 U.S.C. §§ 151-613, separates interstate and intrastate jurisdiction to regulate telecommunications. The FCC has authority under the Act to regulate "interstate and foreign commerce in communication by wire and radio so as to make available, so far as possible, to all the people of the United States, a rapid, efficient Nationwide and world-wide wire and radio communication service." 47 U.S.C. § 151. At the same time, however, the Act in § 2(b)(1) denies the FCC authority over intrastate communications. That section provides in pertinent part:

> [N]othing in this chapter shall be construed to apply or to give the Commission jurisdiction with respect to (1) charges, classifications, practices, services, facilities, or regulations for or in connection with

> intrastate communication service by wire or radio of any carrier . . . .

47 U.S.C. § 152(b)(1).

In *Computer III*, the FCC issued orders preempting nearly all state regulation of enhanced services by communications common carriers, including state tariffing of enhanced services, structural separation requirements and nonstructural safeguards inconsistent with or more stringent than the FCC's nonstructural safeguards. *See California I*, 905 F.2d at 1239. The preemption was clearly broad enough to cover regulation of the provision of enhanced services on both an intrastate and interstate basis. Petitioners in that case contended that the preemption violated § 2(b)(1) by ousting the states of jurisdiction Congress had granted them.

In *California I* we looked to the FCC's argument that the preemption in that case was valid because the state regulations could not feasibly coexist with the *Computer III* scheme. 905 F.2d at 1242-1243. We agreed with the Commission that the Supreme Court's decision in *Louisiana Public Service Commission v. FCC*, 476 U.S. 355 (1986), recognizes an "impossibility" exception to § 2(b)(1). We quoted with approval the D.C. Circuit's decision in *National Ass'n of Regulatory Util. Comm'rs v. FCC*, 880 F.2d 422, 429 (D.C. Cir. 1989), that the only limitation on a state's authority over intrastate telephone service is "when the state's exercise of that authority negates the exercise by the FCC of its own lawful authority over interstate communication." *California I* at 1243.

We went on to recognize, however, that the impossibility exception is narrow, and that the FCC has the burden of showing that the state regulation would negate valid FCC regulatory goals. We held that the FCC had not justified the broad preemption provisions of *Computer III*, and we therefore remanded. *Id.* at 1244.

On remand, the FCC acknowledged that "[p]reemption of state regulation in this area should be as narrow as possible to accommodate differing state views while preserving federal goals." *Order on Remand*, 6 F.C.C.R. at 7631. Consequently, the FCC issued a preemption order that was narrower than the order it issued in *Computer III*. First, with regard to structural separation, the FCC preempted only state requirements for structural separation of facilities and personnel used to provide the intrastate portion of jurisdictionally mixed enhanced services. The FCC did not preempt state regulations that require a separate corporate entity with separate books of account for provision of such services. The FCC also declined to preempt any state structural separation requirements with respect to enhanced services that are offered on a purely intrastate basis. Second, the FCC preempted state CPNI regulations that require prior authorization inconsistent with that required in the *Order on Remand*. Third, the FCC preempted state rules that require initial disclosure of network changes at a different time than the network disclosure rules in the *Order on Remand*.

In its petition for review to this court, New York's principal contention is that the FCC may preempt state action only when it is acting pursuant to specified regulatory duties under Title II of the Act, such as setting tariffs. It contends that in this case, the FCC's action is intended to implement the more general goals of Title I and hence no preemption authority exists under *Louisiana*.

This position must be rejected. The Supreme Court's opinion in *Louisiana* is not so narrowly restricted. Although the Court discussed a Title II function in the paragraph to which it appended the footnote that suggested the 'impossibility' exception, *see Louisiana*, 476 U.S. at 375 & n.4, we do not ascribe any significance to this placement. The argument that the Court made with respect to Title I on the preceding page, that section 152(b) of the Act "constitutes . . . a congressional *denial* of power to the FCC" to regulate, *id.* at 374, applied

to Title II as well as Title I. We recognized in *California I*, moreover, that the impossibility exception applied to FCC preemption action designed to achieve the same regulatory goals it seeks to achieve here. 905 F.2d at 1243. Indeed, we noted specifically that the FCC acted pursuant to Title I of the Act. *See id.* at 1240-41 n.35. The difficulty with *Computer III* was the FCC's failure to justify the breadth of the preemption in that order, not its jurisdiction to order any preemption.

The only remaining question, raised by California and other intervening states, is whether the FCC has indeed justified the extent of its preemption as sufficiently narrowly tailored under the impossibility exception. On remand, the FCC preempted state regulations requiring separate facilities and personnel for the intrastate portion of enhanced services that are offered both interstate and intrastate. The FCC determined that it would not be economically feasible for the BOCs to offer the interstate portion of such services on an integrated basis while maintaining separate facilities and personnel for the intrastate portion. Thus, the FCC concluded, the BOCs would opt to comply with state requirements and provide such services entirely on a structurally separated basis.

[9] The FCC has presented adequate record support for its conclusion that because of economic and operational factors, enhanced service providers would separate their facilities for services that are offered both interstate and intrastate, thereby essentially negating the FCC's goal of allowing integrated provision of enhanced and basic services. We agree with the FCC that the situation presented here is similar to that presented in *North Carolina Utils. Comm'n v. FCC*, 537 F.2d 787 (4th Cir.), *cert. denied*, 429 U.S. 1027 (1976), and *North Carolina Utils. Comm'n v. FCC*, 552 F.2d 1036 (4th Cir.), *cert. denied*, 434 U.S. 874 (1977) (the *NCUC* cases), which were the cases that the *Louisiana* Court suggested would warrant application of an impossibility exception. 476 U.S. at 375 n.4. In the *NCUC* cases, the Fourth Circuit upheld the FCC's preemption of state regulations barring the use of customer pro-

vided telephone equipment for intrastate service, because they conflicted with the FCC's regulations allowing customers to provide their own telephones for interstate service. The Fourth Circuit acknowledged that it was possible to comply with both the states' and the FCC's regulations: customers could have one telephone for interstate use and one for intrastate use. The court nevertheless agreed with the FCC that it was highly unlikely, due to practical and economic considerations, that customers would maintain two separate phones and, therefore, that customers would use telephone company equipment to comply with state regulations. *NCUC*, 552 F.2d at 1043. Because the state regulations would effectively negate the FCC's regulation authorizing the use of customer provided equipment for interstate services, the Fourth Circuit upheld the FCC's preemption. *Id.*

[10] Here, as in the *NCUC* cases, the FCC acknowledges that the BOCs could comply with structural separation requirements, but contends that it would not be economically or operationally feasible for them to do so. The BOCs would be forced to comply with the state's more stringent requirements, or choose not to offer certain enhanced services, thereby defeating the FCC's more permissive policy of integration. We conclude that the impossibility exception, as applied in the *NCUC* cases, authorizes the FCC's preemption of state structural separation requirements here.

[11] We also affirm the FCC's preemption of state regulations regarding CPNI and network disclosure rules. The FCC has shown that conflicting state rules regarding access to CPNI would negate the FCC's goal of allowing the BOCs to develop efficiently a mass market for enhanced services for small customers. The FCC has also demonstrated that compliance with conflicting state and federal network disclosure rules would in effect be impossible.

[12] In sum, the FCC's order adequately responds to our directive that "the FCC bears the burden of justifying its

entire preemption order by demonstrating that the order is narrowly tailored to preempt *only* such state regulations as would negate valid FCC regulatory goals." *See California I*, 905 F.2d at 1243. The FCC has met its burden of showing that its regulatory goals of authorizing integration of services would be negated by the state regulations it has preempted. We therefore conclude that the FCC has satisfied our concerns expressed in *California I* and that the preemption aspects of the *Order on Remand* should be upheld.

IV. CONCLUSION

On our review of the *Order on Remand*, we conclude that the FCC's nonstructural safeguards against cross-subsidization adequately respond to our concerns in *California I*, but that the FCC has failed to explain or justify its change in policy regarding nonstructural safeguards against access discrimination. For this reason, the FCC's cost benefit analysis is flawed and that portion of its order is arbitrary and capricious. We uphold those portions of the *Order on Remand* that implement CPNI rules and that preempt state regulations.

WE GRANT THE PETITION FOR REVIEW, VACATE IN PART THE ORDER ON REVIEW, AND REMAND TO THE COMMISSION FOR FURTHER PROCEEDINGS CONSISTENT WITH THIS OPINION.

REPORT AND ORDER OF THE FEDERAL COMMUNICATIONS COMMISSION

(Adopted November 21, 1991)

[7571] Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

FCC 91-381
38281

CC Docket No. 90-623

In the Matter of

Computer III Remand Proceedings:
Bell Operating Company Safeguards and Tier 1
Local Exchange Company Safeguards

REPORT AND ORDER

Adopted: November 21, 1991
Released: December 20, 1991

By the Commission: Commissioner Duggan issuing a statement.

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I. *Introduction*

1. In this *Report and Order,* we reverse our determination in *Computer II* and the *BOC Separation Order* to impose structural separation requirements for the provision of enhanced services by the Bell Operating Companies (BOCs). In place of structural separation, we adopt effective regulatory safeguards that will permit the BOCs to provide enhanced services to the public in ways that will best further the public interest and serve American consumers. After close examination, we decline to preempt all the state regulation preempted in *Computer III*, but do preempt certain forms of state regulation that would thwart or impede federal objectives.

2. A technologically innovative and economically efficient telecommunications infrastructure is central to continued United States prominence in an increasingly information-oriented global economy. We should remove unnecessary regulatory barriers that impede the responsiveness of American companies to marketplace incentives that foster increasing use and advancement of the nations's telecommunications assets. At the same time, it is critical to the development of full and fair competition to establish and maintain effective regulatory safeguards against anticompetitive conduct by regulated communications common carriers when they seek to participate in the enhanced services industry. Further, this Commission has a duty under the Communications Act to protect regulated service ratepayers by guarding against cross-subsidy between basic and enhanced services. We initiated this proceeding in response to the Ninth Circuit's decision in *California v. FCC,* which vacated three *Computer III* orders.

[7573] II. *Background*

3. In *Computer II* the Commission determined that enhanced services and customer premises equipment (CPE) should not be provided as tariffed services pursuant to Title II of the Communications Act, and established rules to govern the participation of telecommunications common carriers in those activities.[1] The Commission required AT&T to establish subsidiaries for enhanced services and CPE that were fully separated from all of AT&T's common carrier operations.[2] After the United States District Court for the District of Columbia adopted the Modification of Final Judgment (MFJ),[3] which resulted in the divestiture by AT&T of the BOCs, the Commission adopted an order requiring the BOCs to adhere to the structural separation requirements for CPR and enhanced services that *Computer II* had imposed upon the predivestiture AT&T. The Commission committed to review those requirements in two years.[4]

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[1] Amendment of Section 64.702 of the Commission's Rules and Regulations (*Computer II*), 77 FCC 2d 384, 428-430, paras. 114-118 (1980) (*Final Decision*), *modified on recon.*, 84 FCC 2d 50 (1981) (*Reconsideration Order*), *modified on further recon.*, 88 FCC 2d 512 (1981) (*Further Reconsideration Order*), *affirmed sub nom.*, Computer and Communications Industry Ass'n v. FCC, 693 F.2d 198 (D.C. Cir. 1982), *cert. denied*, 461 U.S. 938 (1983).

[2] *Final Decision*, 77 FCC 2d at 475-486, paras. 233-260; *Reconsideration Order*, 84 FCC 2d at 75-86, paras. 72-105; 47 C.F.R. §64.702.

[3] United States v. AT&T, 552 F.Supp. 131 (D.D.C. 1982), *affirmed sub nom.*, Maryland v. United States, 460 U.S. 1001 (1983).

[4] Policy and Rules Concerning the Furnishing of Customer Premises Equipment, Enhanced Services and Cellular Communications Equipment by the Bell Operating Companies,

(Footnote Continued on Following Page)

4. More than two years after the divestiture occurred, the Commission re-examined the *Computer II* separate subsidiary requirements in light of the changes in the industry and the difficulties that the requirements had created for the day-to-day operations of the affected companies. In a series of orders, the Commission removed the CPE and the enhanced service separation requirements for both AT&T and the BOCs. The enhanced service separate subsidiary requirements were replaced with a regime of Open Network Architecture (ONA) requirements and accounting and other nonstructural safeguards. Although removal of AT&T separation requirements and BOC CPE separation requirements were not challenged, the decision to permit the BOCs to provide enhanced services on an integrated basis provoked appeals that led to an opinion by the Court of Appeals for the Ninth Circuit, [7574] which vacated three orders in the *Computer III* proceeding.[5] The

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(Footnote Continued from Previous Page)

CC Docket No. 83-115, *Report and Order*, 95 FCC 2d 1117, 1120, para. 3 (1984) (*BOC Separation Order*), *affirmed sub nom.* Illinois Bell Telephone Co. v. FCC, 740 F.2d 465 (1984), *affirmed on recon.*, FCC 84-252, 49 Fed. Reg. 26056 (1984) (*BOC Separation Reconsideration Order*), *affirmed sub nom.*, North American Telecommunications Association v. FCC, 772 F.2d 1282 (7th Cir. 1985).

[5] Amendment of Sections 64.702 of the Commission's Rules and Regulations, (*Computer III*), CC Docket No. 85-229, Phase I, *Report and Order*, 104 FCC 2d 958 (1986) (*Phase I Order*), *recon.*, 2 FCC Rcd 3035 (1987), (*Phase I Reconsideration Order*), *further recon.*, 3 FCC Rcd 1135 (1988) (*Phase I Further Reconsideration Order*), *second further recon.*, 4 FCC Rcd 5927 (1989) (*Phase I Second Further Reconsideration Order*), *Phase I Order* and *Phase I Reconsideration Order vacated sub nom.*, California v. FCC, 905 F. 2d 1217 (9th Cir. 1990) (*California*); Phase II, CC Docket No. 85-229, 2 FCC Rcd 3072 (1987) (*Phase II Order*), *recon.*, 3 FCC

(Footnote Continued on Following Page)

Court of Appeals concluded that the Commission decision to rely on nonstructural safeguards in lieu of structural separation to protect against cross-subsidization of enhanced services by the BOCs had not been adequately justified when adopted.[6] The Court noted, however, that the Commission could have justified its decision on the grounds "that the national interest in allowing the BOCs to compete more efficiently in the enhanced services industry justified reduced regulatory protection against cross-subsidization," but stated that "this is not the case before us."[7]

5. The Commission subsequently issued a *Notice* in this remand proceeding, proposing to permit the BOCs to provide enhanced services pursuant to a strengthened set of nonstructural safeguards that would effectively protect against cross-subsidization and discrimination, while furthering the Commission's goals of a technologically innovative and economically efficient telecommunications infrastructure. The *Notice* also proposed to preempt only those state regulations differing from federal safeguards that would thwart or impede federal policy, such as permitting the integrated provision of interstate basic and enhanced services by the BOCs, AT&T, and the independent telephone companies

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Rcd 1150 (1988) (*Phase II Reconsideration Order*), *further recon.*, 4 FCC Rcd 5927 (1989) (*Phase II Further Reconsideration Order*), *Phase II Order vacated sub nom.*, California v. FCC, 905 F.2d 1217 (9th Cir. 1990), *pet. for rev. pending*, BellSouth Corp. v. FCC (9th Cir. No. 88-7290, filed April 20, 1988).

[6] California v. FCC, 905 F.2d 1217 (1990) (*California*).

[7] *Id.* at 1238-1239.

(independents).[8] The *Notice* granted an interim waiver to the BOCs to permit them to provide enhanced services pursuant to previously approved Comparably Efficient Interconnection (CEI) plans pending the completion of this proceeding.[9]

[7575] III. *Regulatory Safeguards Governing BOC Provision of Enhanced Services*

6. A regulatory framework that permits the BOCs to provide enhanced services pursuant to safeguards that will both effectively protect against cross-subsidization and discrimination and encourage efficient use of BOC resources to provide enhanced services will best serve the public interest. Eliminating all structural separation requirements and allowing the BOCs to provide enhanced services pursuant to nonstructural safeguards will permit the BOC's to realize fully their vast potential to provide enhanced services to the public, especially to the consumer market. Removal of structural separation requirements will permit the BOCs to use their extensive resources, including geographically dispersed facilities and the associated management and operational resources, to provide a variety of enhanced services throughout the country. Such an approach will permit the BOCs to use existing marketing contacts with virtually every household within their regions to market enhanced services to consumers inexpensively, to use the same personnel

[8] Computer III Remand Proceedings: Bell Operating Company Safeguards; and Tier 1 Local Exchange Company Safeguards, *Notice of Proposed Rulemaking and Order*, CC Docket No. 90-623, 6 FCC Rcd 174 (1990) (*Notice*).

[9] A list of parties filing comments and replies is contained in Appendix A.

to repair and install the services and equipment necessary to provide basic and enhanced services, and to use their expertise to engage in research and development for enhanced services.

7. Our experience over the last ten years demonstrates that removal of structural separation requirements has resulted and will result in greater BOC participation in the provision of enhanced services. Under the nonstructural safeguards in place through CEI plans and market trials, the BOCs have provided voice mail service, E-Mail, gateways, electronic data interchange, data processing, voice store-and-forward, and fax store-and-forward services. The BOCs' provision of voice mail services is particularly significant. In the relatively brief time that the BOCs have been permitted to provide that service, voice mail has been provided to rapidly increasing numbers of customers in their regions at reasonable prices.

8. By contrast, our experience with structural separation shows that it inhibits BOC provision of enhanced services. Under structural separation, the BOCs provided few enhanced services, and structural separation apparently completely foreclosed BOC provision of voice mail service.[10] Essentially, structural separation prevents the BOCs from using their existing substantial resources to provide enhanced services, requiring instead separation and/or duplication of facilities and personnel to provide both enhanced and basic services. It imposes direct monetary costs, and results in loss of

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[10] American Telephone and Telegraph Co. Petition for Waiver of Section 64.702 of the Commission's Rules and Regulations, 88 FCC 2d 1 (1981) (*Custom Calling Denial Order*).

efficiencies and economies of scope. The BOCs have submitted significant evidence of the financial and operational efficiencies that would be lost under structural separation. Costs for voice mail services could be up to 68% percent higher under structural separation necessitating price increases of up to 30% and 80%.

[7576] 9. We also conclude that the use of our comprehensive set of strengthened nonstructural safeguards instead of structural separation will not result in significant public interest costs. Some commenters claim that a major cost of nonstructural safeguards is that they will be ineffective to protect against anticompetitive conduct by the BOCs in the enhanced services marketplace. As we explain fully below, we have adopted and implemented a comprehensive regulatory framework that provides an effective alternative to structural separation for protection against anticompetitive conduct. To the extent nonstructural safeguards may involve any small diminution in protection against anticompetitive conduct as compared with a structural separation requirement, we conclude that it is outweighed by the substantial benefits of nonstructural safeguards.

10. The *California* Court did not find fault with our determination in *Computer III* that there could be significant public interest benefits from use of nonstructural safeguards. It vacated *Computer III* in its entirety because it concluded that the Commission had not presented sufficient justification for reliance on cost accounting safeguards so soon after the Commission's decision in the *BOC Separation Order* to continue structural separation for BOC enhanced services operations. In response to the Court's

concerns, we first address the proposals in the *Notice,* and adopt a strengthened set of cost accounting safeguards. We then determine that these modified cost accounting safeguards, given our experience with cost accounting safeguards since the *BOC Separation Order* and *Computer III,* constitute an effective alternative to structural separation to protect against cross-subsidy. Further, we adopt various safeguards against discrimination, including: (1) network disclosure rules; (2) nondiscrimination reporting requirements; and (3) revised customer proprietary network information (CPNI) rules. We conclude that these requirements, along with ONA, are an effective alternative to structural separation to guard against anticompetitive conduct by the BOCs affecting the enhanced services marketplace.

11. Having identified a comprehensive set of nonstructural safeguards to protect against cross-subsidization and discrimination, we then assess, in Section D. below, the benefits of eliminating structural separation. We conclude, as indicated, that there are substantial benefits from use of nonstructural safeguards and no significant costs. We therefore permit the BOCs to provide enhanced services pursuant to those nonstructural safeguards instead of the *Computer II* regime of structural separation. We also undertake to review, after three years of a fully effective ONA environment, the working of nonstructural safeguards in light of marketplace developments.

A. *Safeguards Against Cross-Subsidization*

12. In the *Notice,* the Commission evaluated regulatory developments since the *BOC Separation Order* and tentatively concluded that they have

reduced the ability of the BOCs to engage in improper cross-subsidization of their enhanced service operations, as well as their incentives to do so. These regulatory developments were the adoption and implementation of detailed cost allocation rules and related cost accounting safeguards that [7577] separate nonregulated service costs from regulated service costs,[11] the implementation of cost accounting mechanisms to enforce the joint cost rules including the filing and approval of cost allocation manuals, the requirement that carriers submit to independent audits, and the establishment of the Automated Reporting and Management Information System (ARMIS).[12] The Commission also stated that the adoption of price cap regulation for the local exchange carriers (LECs) could, along with cost allocation, reporting, and enforcement safeguards, reduce BOC incentives to cross-subsidize.[13] The Commission observed that its enforcement mechanisms had resulted in vigorous enforcement actions in several instances to assure that improper cross-subsidization

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[11] Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities & Amendment of Part 31, the Uniform System of Accounts for Class A and Class B Telephone Companies to Provide for Nonregulated Activities and to Provide for Transactions Between Telephone Companies and Their Affiliates, CC Docket No. 86-111, 2 FCC Rcd 1298, 1329-1331 (1987) (*Joint Cost Order*), *recon.* 2 FCC Rcd 6283 (1987) (*Joint Cost Reconsideration Order*), *further recon.*, 3 FCC Rcd 6701 (1988) (*Joint Cost Further Reconsideration Order*), *affirmed sub nom.*, Southwestern Bell Corporation v. FCC, 896 F.2d 1378 (D.C. Cir. 1990).

[12] Automated Reporting Requirements for Certain Class A and Tier 1 Telephone Companies (Parts 31, 43, 67, and 69 of the FCC's Rules), 2 FCC Rcd 5770 (1987) (*ARMIS Order*), *recon.*, 3 FCC Rcd 6375 (1988).

[13] *Notice*, 6 FCC Rcd at 178, para. 25.

did not occur.[14] In addition to these regulatory developments, however, the Commission proposed to strengthen in five ways its existing cost accounting safeguards applicable to the BOCs and other Tier 1 LECs. The Commission stated that these measures would provide regulated ratepayers and the BOCs' (and other Tier 1 LECs') competitors with important additional protections against cross-subsidization. The Commission tentatively concluded that its existing and proposed cost accounting safeguards would effectively protect ratepayers and others from cross-subsidization and the effects thereof, and that structural separation is not necessary to protect against cross-subsidization.

13. In this *Report and Order,* we determine that our existing cost accounting safeguards and those proposed in the *Notice* constitute a realistic and reliable alternative to structural separation to protect against cross-subsidy. These cost accounting safeguards, along with our safeguards against discrimination, will permit realization of the public interest benefits of integrated provision by the BOCs of basic and enhanced services without creating substantial risks of cross-subsidization in comparison to structural separation. We also determine that the adoption of price cap regulation for the LECs constitutes an effective complement to cost allocation, reporting, and enforcement safeguards, to reduce BOC incentives [7578] to cross-subsidize.[15] We address first adoption of the strengthened cost accounting safeguards proposed in the Notice and then address the effectiveness of these cost accounting safeguards to protect against cross-subsidization.

[14] *Id.* at 177-178, paras. 18-23.

[15] *Id.* at 178, para. 25.

1. *Adoption of Strengthened Cost Accounting Safeguards*

14. The *Notice* proposed, in addition to the panoply of existing cost accounting, reporting, and enforcement safeguards, that: (1) LECs treat enhanced services as nonregulated activities for accounting and jurisdictional separations purposes; (2) independent auditors provide the same level of assurance in audits conducted pursuant to the joint cost rules as that undertaken in a financial statement audit engagement; (3) the Common Carrier Bureau study means of achieving greater uniformity in the carriers' cost allocation manuals and, if appropriate, take steps necessary to accomplish this goal; (4) carriers quantify the effects of cost allocation manual changes when such changes are submitted to the Commission; and (5) the Bureau study whether to establish a reasonable threshold for determining the materiality of errors and omissions discovered in the independent audits of carrier filings, and, if appropriate, take steps necessary to implement such a threshold.[16] We address these proposals in turn.

a. Nonregulated Treatment of Enhanced Services for Federal Accounting and Jurisdictional Separations Purposes

15. The first accounting proposal involves continued nonregulated treatment of enhanced services for accounting and cost allocation purposes. Under such treatment, the costs of nonregulated activities are removed from the carriers' prescribed Part 32 accounts prior to the jurisdictional separations process.

[16] *Notice*, 6 FCC Rcd at 178, para. 26.

16. *Comments.* Our proposal to require carriers to treat enhanced services as nonregulated activities for accounting and jurisdictional separations purposes is supported by virtually all of the LECs commenting on this issue, as well as by a trade association of equipment manufacturers.[17] The LECs commend the proposal as an effective measure to ensure that interstate ratepayers do not bear costs associated with enhanced services.[18] They state that continued treatment of enhanced services as nonregulated activities will allow carriers to utilize their existing accounting systems and will enable the Commission to achieve its policy goals without adversely [7579] affecting the rights of the states.[19] The LECs contend that subjecting enhanced service costs to jurisdictional separations would be unnecessary, difficult to administer and audit, and require costly modifications to the Commission's cost allocation process and access charge rules, the carriers' internal accounting systems, and ARMIS, the Commission's Automated Reporting Management Information System.[20]

17. The majority of comments filed in this proceeding by states, state agencies and commissions, and their representatives do not address this

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[17] CBEMA Comments at 6.

[18] USTA Comments at 6; Ameritech Comments at 15-16; NYNEX Comments at 35; Pacific Comments at 39; U S West Comments at 102.

[19] BellSouth Comments at 19; Bell Atlantic Comments at 19. *See also* USTA Comments at 6-7; Ameritech Comments at 17; Pacific Comments at 39-40; SNET Comments at 10.

[20] USTA Comments at 6-7; Ameritech Comments at 15-17; Pacific Comments at 39-40; BellSouth Comments at 19; Cincinnati Bell Comments at 3; SNET Comments at 10.

question.[21] One state commission, the Michigan PSC, support continued nonregulated treatment of enhanced services.[22] On the other hand, the Southwest Regional Regulatory Group (SWRRG), representing five state commissions, objects to the proposal, arguing that its adoption would constitute unwarranted preemption of state regulation of a number of enhanced services that are "solely intrastate or local in their use of the network."[23] The California PUC further argues that Section 410(c) of the Communications Act compels the Commission to apportion enhanced service costs between the federal and state jurisdictions.[24] Finally, the District of Columbia PSC contends that the proposal shifts cost allocation problems for enhanced services from this Commission to the state commissions. In reply, NYNEX states that our proposal should not affect state regulation of enhanced services because states regulating rates for enhanced services could consider the total fully allocated enhanced service costs and thereby prevent cross-subsidization.[25]

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[21] Colorado Public Utilities Commission, Florida Public Service Commission, Hawaii, Illinois Commerce Commission, New York Public Service Commission, Oregon Public Utilities Commission, Pennsylvania Office of Consumer Advocate, Vermont Department of Public Service, Washington Utilities and Transportation Commission, National Association of Regulatory Utility Commissioners.

[22] Michigan PSC Comments at 6-7.

[23] SWRRG Comments at 9. The Southwest Regional Regulatory Group includes the Arkansas Public Service Commission, Kansas Commerce Commission, Missouri Public Service Commission, Oklahoma Commerce Commission, and the Public Utilities Commission of Texas.

[24] California PUC Comments at 11-12.

[25] NYNEX Reply at 30-31.

[7580] 18. *Discussion.* We conclude that enhanced services should be treated as nonregulated services for accounting and jurisdictional separations purposes. Our accounting rules specify that activities never subject to regulation are to be classified as "nonregulated."[26] The Commission first defined "enhanced services" during the *Computer II* proceeding, and concluded that enhanced services are not common carrier services and should not be regulated under Title II of the Communications Act.[27] Exchange carrier enhanced services have never been treated as regulated activities for purposes of the accounting or jurisdictional separations rules. We see no reason to change that treatment now.

19. Significantly, as many commenters note, changes in our accounting treatment of enhanced services are entirely unnecessary to protect against improper cross-subsidy. Application of the joint cost rules already ensures that interstate ratepayers do not bear costs associated with enhanced services. By contrast, treating enhanced service costs as regulated for accounting and jurisdictional separations purposes would require large scale modifications in the Commission's existing regulatory processes as well as in the carriers' internal accounting systems. For instance, jurisdictional separations would need to be amended in order to address enhanced service costs. Expanding the separations process to deal with all LEC-provided enhanced services would be a massive undertaking. The carriers would also likely incur substantial costs to revise their accounting systems and to prepare studies necessary to adopt

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[26] 47 C.F.R. §32.23(a).

[27] *Final Decision*, 77 FCC 2d at 428-32.

separations methodologies applicable to enhanced services. The difficulty, complexity, and expense for regulators and the carriers would be exacerbated by the lack of historical data or previous studies regarding the jurisdictional usage of enhanced services.

20. Our decision not to subject enhanced service costs to jurisdictional separations does not represent, as SWRRG and the California PUC suggest, preemption of state regulation. Absent jurisdictional separations, states that choose to regulate rates for intrastate enhanced services are generally free to do so.[28] There is little, if any, state regulation of enhanced service rates at this time.[29] Therefore, undertaking [7581] the burden of formulating and operating jurisdictional separations rules for enhanced services is neither necessary nor warranted. A state choosing to regulate enhanced service rates should bear the effort and expense associated with such regulation.

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[28] Classification of Inside Wiring Services for Accounting Purposes, *Memorandum Opinion an Order on Review*, 5 FCC Rcd 3521 (1990), *recon. dismissed*, FCC 91-387 (adopted November 21, 1991).

[29] On May 16, 1991, the Federal-State Joint Conference on Open Network Architecture adopted a resolution that enhanced services should not be subject to tariffing or entry/exit regulation. NTIA notes that enhanced services "are not per se regulated by the Commission or, presently, by the states." NTIA Comments at 13. Contrary to the argument advanced by the California PUC, *see* California PUC Comments at 12, section 410(c) of the Communications Act does not require that we apply jurisdictional separations procedures to non-common carrier services, such as enhanced services. *See Detariffing the Installation and Maintenance of Inside Wiring, (Third Report and Order)*, CC Docket No. 79-105, FCC 91-386 (adopted November 21, 1991).

b. Independent Audits

21. The *Notice* proposed to strengthen the standard to be used by independent auditors in preparing their reports on carriers' cost allocation manual implementation and results. The joint cost rules required the independent audit reports to meet the professional standards for an attest audit.[30] Specifically, we proposed to require carriers' independent auditors: (a) to provide the same level of assurance in their audits as that undertaken in a financial statement audit engagement, (b) to render an opinion on whether the carrier's cost allocation methodologies are in conformity with its cost allocation manual and whether the results fairly present the results of the company's operations, and (c) to evaluate and report upon the carriers' internal controls when auditors rely upon those controls in determining the extent of auditing procedures.[31]

22. *Comments.* Some commenters contend that the benefits do not justify the additional costs associated with changes to the independent audit requirement.[32] USTA, the American Institute of Certified Public Accountants (AICPA), and several LECs support the proposal but recommend modifications. AICPA and several LECs suggest changing the wording of the "presents fairly" requirement.[33] Some parties suggest that the

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[30] *See* note 11, *supra.*

[31] In late 1990, the Common Carrier Bureau's Accounting and Audits Division imposed similar standards on a one-time basis for purposes of the independent audit reports for 1990 operations. Responsible Accounting Office (RAO) Letter 12, DA90-1491, revised October 19, 1990, released October 23, 1990.

[32] Contel Comments at 10; GTE Comments at 9.

[33] AICPA Comments at 9; *see also* USTA Comments at 8; Ameritech Comments at 18; Bell Atlantic Comments at 18; US West Comments at 102-103; SNET Comments at 11.

Commission explicitly require compliance with the professional audit standards contained in the Generally Accepted Auditing Standards (GAAS), noting that the *Notice* mentions only two of the ten standards contained in GAAS. Finally, some parties object to the proposed requirement for a separate report on the adequacy of carriers' internal controls, claiming that the proposal is unnecessary because GAAS already requires an evaluation of internal controls as part of a financial statement audit, and a separate report would increase the expense of the audit.

[7582] 23. *Discussion.* We here adopt our proposal to strengthen the independent audit requirement, with some minor modifications. We conclude that the independent auditors should provide the same level of assurance as that provided in a financial statement audit engagement.[34] USTA, supported by several LECs, proposes language that makes clear that the independent auditors are to evaluate the results of applying carriers' cost allocation manuals in light of the requirements of the manuals as well as our joint cost rules and other pertinent regulations.[35] We agree that we should state

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[34] *Notice*, 6 FCC Rcd at 178. The AICPA and several LECs suggest amending the wording of the proposed rule. The AICPA suggests language that would effectively lessen the standard, but did not explain its rationale for proposing such language. AICPA Comments at 9; *see also* Ameritech Comments at 18. We decline to adopt AICPA's proposed language because it would reduce the effectiveness of the independent audit as a safeguard against cross-subsidization.

[35] USTA's proposed language precisely tracks the wording of the sample opinion letter appended to RAO Letter 12, which imposed one-time strengthened requirements for the 1990 independent

(Footnote Continued on Following Page)

specifically the regulatory requirements to be considered by the independent auditors, and therefore incorporate the suggested language in section 69.904 of our rules.

24. We also require that independent auditors follow GAAS. The *Notice* referred to the professional standards governing independent auditors. Independent auditors must follow all of the ten standards of GAAS in preparing the required reports. At the same time, however, we specifically do not disclaim our authority, for purposes of regulatory compliance, to prescribe the manner in which the independent audit reports are prepared and presented. For that reason, as is currently the case with respect to the application of generally accepted accounting principles (GAAP),[36] we shall state explicitly in our rules that GAAS shall control only insofar as it is not inconsistent with the rules or directives of the Commission (or its staff on delegated authority). Finally, we agree with the AICPA and several of the LECs that adoption of GAAS by reference obviates the [7483] need for a duplicative report on the carriers'

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audits. That language requires an independent audit "that provides a positive opinion on whether the applicable date shown in the carrier's annual report required by Section 43.21(f)(2) of this Chapter presents fairly, in all material respects, the information of the carrier required to be set forth therein in accordance with the carrier's cost allocation manual, the Commission's Joint Cost Orders issued in conjunction with CC Docket No. 86-111, and the Commission's rules and regulations thereto including Sections 32.23, 32.27, 64.901 and 64.903 in force as [of] the date of the auditor's report." USTA Comments at 9.

[36] 47 C.F.R. §§32.12(a) and 32.16(a).

internal controls. Accordingly, we shall not require such a report.[37]

c. Uniformity in Cost Allocation Manuals

25. In the *Notice* we proposed to require the Common Carrier Bureau to study a means of achieving greater uniformity in the carriers' cost allocation manuals.

26. *Comments.* Several state and federal agencies and other commenters support that proposal.[38] ADAPSO argues that the Commission should mandate uniformity and not defer to the judgment of the Common Carrier Bureau.[39] The Alarm Industry and MCI both contend that we should specify detailed proposals and timetables for achievement of greater uniformity in carrier cost allocation manuals.[40]

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[37] For the past four years, the independent audit requirement has proven to be extremely useful in reviewing implementation of the carrriers' cost allocation manuals and the results of cost allocations under the manuals. Our proposal to strengthen the financial audit standard for independent audits represents not a failure of our accounting safeguards, but rather an effort to fine-tune a measure that has been highly effective since its adoption. As explained elsewhere in this Order, the independent audit, while valuable, is only one of several measures that comprise our set of cost accounting safeguards. As to the Alarm Industry's request that we adopt procedures to discourage opinion shopping in selecting independent auditors, we see no reason to change our disposition of that matter in this proceeding. *See Joint Cost Order*, 2 FCC Rcd at 1331-1333. We can revisit the issue later if opinion shopping ever becomes a significant obstacle to the independent audit process.

[38] NTIA Comments at 13; Hawaii PUC Comments at 13; Illinois CC Comments at 7; Michigan PSC Comments at 8; SWRRG Comments at 10; CBEMA Comments at 6; Ad Hoc Users Comments at 28.

[39] ADAPSO Comments at 35.

[40] Alarm Industry Comments at 10; MCI Comments at 61.

27. The LECs support efforts to promote cost allocation manual uniformity, but generally oppose a requirement of absolute uniformity in cost allocation practices. They argue that complete cost allocation manual uniformity among carriers is inconsistent with the principle of cost causation set forth in the *Joint Cost Order*,[41] and that requiring a uniform set of cost pools would force a carrier to create cost pools that it would not utilize, contrary to Commission orders requiring carriers to remove [7584] hypothetical cost pools from their cost allocation manuals.[42] These parties state that complete uniformity in most accounts, cost pools, and apportionment and time reporting methods is not possible due to differences among the LECs' operations, organizations, records, systems, and nonregulated activities.[43] They argue that cost

[41] USTA Comments at 10; BellSouth Comments at 21-22; NYNEX Comments at 38; Pacific Comments at 42; SWBT Comments at 34; US West Comments at 103-04; Centel Comments at 5-6; Cincinnati Bell Comments at 4.

[42] USTA Comments at 11; Bell Atlantic Comments at 20; BellSouth Comments at 22; SWBT Comments at 33-34; US West Comments at 104. Under section 64.901 of the Commission's Rules, 47 C.F.R. §64.901, costs which cannot be directly assigned to either regulated or nonregulated activities are considered common costs. Common costs are grouped into homogeneous cost categories, or cost pools, to facilitate the proper allocation of costs between a carriers' regulated and nonregulated activities in accordance with a hierarchy of preferred cost allocation techniques. *See also Joint Cost Order*, 2 FCC Rcd at 1343, Appendix B.

[43] USTA Comments at 10; Ameritech Comments at 19; Bell Atlantic Comments at 20; BellSouth Comments at 21-22; NYNEX Comments at 37-38; Pacific Comments at 42; SWBT Comments at 32-33; US West Comments at 103-04; Centel Comments at 6; Cincinnati Bell Comments at 3-4; GTE Comments at 13-14; Rochester Comments at 9; SNET Comments at 12-13.

allocation manual revisions to implement a uniformity requirement would be administratively inconvenient and costly, disrupt quarterly cost allocation manual filings, interrupt year-to-year tracking of actual business specific expenditures, and potentially create an adverse effect upon annual access tariff filings through changing allocation methods.[44] Finally, they claim that a requirement of uniformity could delay the introduction of new enhanced services and carrier reaction to competitive opportunities due to the need to develop uniform industry procedures.[45]

28. *Discussion.* Increased uniformity in LEC cost allocation practices would facilitate our review of those practices and help ensure that they are reasonable and accurate. Although staff efforts to date have resulted in more uniformity than in the originally filed cost allocation manuals, we conclude that even greater uniformity in cost allocation practices is highly desirable to the extent feasible. The benchmarking process facilitated by ARMIS should prove still more effective if greater uniformity in carriers' cost allocation processes can be accomplished. Moreover, this goal should be met expeditiously.

29. We therefore direct the Common Carrier Bureau to analyze the cost allocation practices of subject carriers to determine ways to obtain greater uniformity in carriers' cost allocation procedures and practices. The Bureau is further directed to prepare a

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[44] Centel Comments at 7; Cincinnati Bell Comments at 4-6; Rochester Comments at 8-9; SWBT Comments at 33-34;

[45] USTA Comments at 11; Ameritech Comments at 20; BellSouth Comments at 22; US West Comments at 104; SNET Comments at 13.

request for comments addressing proposed uniformity requirements and to promulgate uniformity requirements [7585] upon delegated authority. This effort is a matter of significant priority. We direct the Bureau to proceed on an expedited basis in implementing cost allocation requirements that produce greater uniformity among carrier practices.[46]

d. Quantification of the Effects of Cost Allocation Manual Changes

30. Our fourth accounting proposal involves quantification of the effects of revisions to the cost allocation manuals. The *Notice* indicated that such estimates could assist Commission staff as well as interested parties in focusing attention on the most significant manual revisions.

31. *Comments.* Federal and state agencies support this proposal,[47] although the DC PSC expresses general reservations regarding the cost allocation process.[48] the Ad Hoc Users also support the proposal.[49]

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[46] The carriers have asserted, and no one has disputed, that absolute uniformity would be nearly impossible to achieve given the differences in the business operations, systems, and records of the subject carriers. In light of the undisputed disparities in carrier operations, it would not be prudent to impose an immediate requirement of absolute uniformity and we do not do so.

[47] NTIA Comments at 13; DC PSC Comments at 25-26; Hawaii PUC Comments at 13; Illinois CC Comments at 6; Michigan PSC Comments at 8-9; SWRRG at 10.

[48] DC PSC Comments at 25-26.

[49] Ad Hoc Users Comments at 29, Appendix 1 at p. 5.

32. Some LECs claim that quantification is unnecessary, irrelevant, burdensome, and that its cost would outweigh any benefits.[50] Other LECs argue that quantification would be difficult because carriers do not have systems in place to quantify changes at the cost pool level.[51] Several carriers contend that the financial impact of new ventures (or of cost allocation manual changes generally) may not be known at the time that these changes are filed.[52] NYNEX claims that the filing of financial impact estimates would reveal proprietary information concerning new nonregulated service offerings. [53] A few LECs suggest that the quantification requirement proposed in the *Notice* be replaced with a requirement that carriers state whether the effect of a cost allocation manual revision exceeds a specified [7586] threshold amount.[54] The majority of LECs argue that carriers should be allowed to provide a range of the estimated dollar effects of any cost allocation manual changes.[55]

33. *Discussion.* The purpose of quantifying the effects of revisions to cost allocation manuals is to help interested parties and Commission staff to identify changes in cost allocations that potentially

[50] Centel Comments at 8; SNET Comments at 14; US West Comments at 105.

[51] USTA Comments at 12; BellSouth Comments at 23.

[52] NYNEX Comments at 40; Pacific Comments at 43-44; US West Comments at 104-05; Cincinnati Bell Comments at 6-7.

[53] NYNEX Comments at 40.

[54] Bell Atlantic Comments at 21; NYNEX Comments at 41; SWBT Comments at 35; Cincinnati Bell Comments at 7; Rochester Comments at 11.

[55] USTA Comments at 12-13; Ameritech Comments at 20-21; BellSouth Comments at 24; Pacific Comments at 44; SWBT Comments at 35; Cincinnati Bell Comments at 6-7; GTE Comments at 14-15; Rochester Comments at 11; SNET Comments at 14.

could have a significant impact on regulated and nonregulated activities. We conclude that requiring quantification of cost allocation manual changes to the nearest $100,000 strikes a reasonable balance between relieving the carriers of the burden of precise quantification and preserving the ultimate usefulness of quantification of cost allocation manual revisions. Quantification would not need to be provided for a change with a financial impact of less than $100,000.

34. The reporting ranges proposed by the LECs are so broad that the information provided would be meaningless. USTA, supported by numerous LECs, propose the following ranges: for balance sheet effect, $0-10 million, $10-50 million, and greater than $50 million; for income statement effect $0-1 million, $1-10 million, $10-50 million, and greater than $50 million.[56] We do not believe that the relative significance of cost allocation manual changes could be ascertained if such large ranges were used.

35. Some commenters have requested that carriers be allowed to quantify changes at the account level rather than at the more detailed cost pool level.[57] We conclude that the level of quantification should not be the same for all types of manual changes. There are three types of manual changes that are susceptible to quantification: (1) changes in time reporting procedures; (2) changes related to affiliate transactions; and (3) changes in the cost apportionment tables. Cost allocation manual changes related to time reporting and affiliate

[56] *Ex Parte* Letter from Martin McCue, Vice President and General Counsel, United States Telephone Association, to Donna R. Searcy, Secretary, FCC, June 26, 1991.

[57] *E.g.*, Cincinnati Bell Comments at 6-7.

transactions generally occur at or above the account level. In addition, such quantification at the more detailed cost pool level would be very difficult. We therefore require, at a minimum, that carriers quantify changes in time reporting and affiliate transaction at the account level.

[7587] 36. Changes in the cost apportionment tables, on the other hand, generally are made at the cost pool level and carriers reasonably can be required to quantify the effects of those changes at that level. Moreover, if quantification were to take place at the account level, simultaneous changes in several cost pools within a given account could offset one another in the quantification process and thereby mask significant changes in the results at the cost pool level. Thus, the reporting of changes only at the account level might not reveal significant changes at the cost pool level. Such a result would frustrate the purpose of adopting a requirement that carriers quantify the effects of cost allocation manual changes. We therefore require that changes to cost apportionment tables be quantified at the cost pool level.

e. Materiality Threshold of Errors and Omissions

37. We also proposed to direct the Common Carrier Bureau to study whether to establish a reasonable threshold for determining the materiality of errors and omissions discovered in the independent audits of carrier filings.

38. *Comments.* With the exception of the LECs and the AICPA, all parties commenting upon this issue support the proposal. A few of those

commenters ask that the Commission mandate a materiality threshold rather than deferring to the judgment of the Bureau or that the Commission provide detailed proposals and timetables for establishment of specific standards for the materiality of errors and omissions.[58]

39. The AICPA and the LECs argue that a materiality threshold specified by the Commission may be inconsistent with GAAS.[59] Three carriers contend that if the Commission were to specify a materiality threshold for the planning process of the independent audits, a report based upon such procedures could not be made available for general distribution.[60] BellSouth argues that the cost of the independent audit could escalate dramatically if the Commission were to specify a materiality threshold lower than that already used by independent auditors.[61] Finally, the AICPA and several of the LECs argue that the Commission should refrain from prescribing a materiality threshold for planning the audit and, instead, limit our action [7588] to setting a materiality threshold for purposes of reporting audit results and correcting errors or omissions that exceed the threshold.[62]

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[58] ADAPSO Comments at 35; Alarm Industry Comments at 10; MCI Comments at 61.

[59] AICPA Comments at 10; USTA Comments at 13; Ameritech Comments at 21; BellSouth Comments at 24-26; NYNEX Comments at 41-42; Pacific Comments at 45-46; SWBT Comments at 36-37; US West at 105-106; GTE Comments at 11-13; SNET Comments at 15.

[60] BellSouth Comments at 25-26; SWBT Comments at 36-37; US West Comments at 106.

[61] BellSouth Comments at 26-27.

[62] AICPA Comments at 10; USTA Comments at 13-14; Ameritech Comments at 21; NYNEX Comments at 42-43; Pacific Comments at 46.

40. *Discussion.* It is important that the independent audits serve their intended purpose and that the independent auditors use an appropriate materiality threshold in planning their audits. Materiality thresholds can aid audit planning. Moreover, as the Michigan PSC suggests in its comments, setting a materiality threshold could facilitate consistent review of carriers' cost allocations.[63] In addition, the independent audits of cost allocation manual implementation and results differ from typical audits in that they serve a regulatory purpose.[64] For that reason, it is essential that the materiality thresholds used by the independent auditors in planning their audits are appropriate in order to ensure accurate results of the cost allocations required under our rules.

41. We therefore direct the Common Carrier Bureau to monitor the materiality thresholds used by the various independent auditors to ensure that each threshold is suitable for the operations of the carrier(s) for which it is employed. In addition, we hereby authorize the Bureau to take such action regarding the materiality thresholds as it deems necessary to ensure consistent and appropriate independent audits. This authorization includes, but is not limited to, setting a uniform materiality threshold or multiple materiality thresholds for different types or sizes of carrier operations. We authorize the Bureau to prescribe materiality thresholds, as necessary, for purposes of planning the independent audits as well as for reporting and correcting errors and omissions to

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[63] Michigan PSC Comments at 9.

[64] McGraw-Hill Reply at 10-11.

carriers' reports to the Commission. Such authority is essential because it is possible that many errors and omissions exceeding a prescribed materiality threshold would not be discovered unless a suitable threshold were also used in planning the audit. We disagree with commenting parties who argue that setting a materiality threshold would interfere impermissibly with the preparation of the independent audit reports.[65]

[7589] 2. *Use of Strengthened Accounting Safeguards to Protect Against Cross-Subsidization*

a. Comments

42. A number of commenters claim that there is no evidence that cost allocation rules can prevent cross-subsidization.[66] These commenters contend that the Commission cannot rely on any form of cost accounting safeguards because those safeguards rely on allocations, rather than isolation of costs through structural separation,[67] and because cost allocations inherently entail an unacceptable potential for

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[65] Parties present their arguments on this issue in relatively conclusory fashion, without reference to specific professional auditing standards to support their position and without explanation of how a prescribed materiality threshold would interfere with preparation of the required audit report.

[66] ANPA Comments at 13; CompuServe Comments at 18-19; CBEMA Comments 5-7; IDCMA Comments at 9-15; Iowa Network Services Comments at 15; MessagePhone Comments at 10; NAB Comments at 4; WUTC Comments at 8-9; Stroh Comments at 1-2.

[67] DC PSC Comments at 17; McRaw Reply at 9-10; Florida Comments at 6; CBEMA Comments at 5; ADAPSO Comments at 9-12; MCI Comments at 49-52; ANPA Comments at 16; CompuServe Comments at 19-20; IDCMA Comments at 10-11.

intentional or inadvertent misallocation of costs.[68] Others argue that accounting safeguards give the BOCs too much discretion in devising allocation formulas,[69] service definitions, and service descriptions,[70] and that the BOCs control the underlying information used to allocate these costs, such as time reporting by repair technicians.[71] MCI also asserts that our cost allocation rules do not prevent cross-subsidization at the intrastate level.[72]

43. Some commenters contend that the Commission does not have the resources available to implement or enforce the cost allocation rules.[73] They claim that ARMIS is inadequate to detect cross-subsidies because the benchmarking process does not reveal subtle cross-subsidies or misallocations common to all of the BOCs.[74] They also argue that the data provided by individual carriers are not comparable, and the form and manner in which the [7590] data are collected keeps changing. Several parties claim that the enforcement actions cited in the *Notice* show not the ability of the Commission to enforce the cost accounting safeguards, but rather the ability of the BOCs to succeed in cross-subsidization.[75] Some parties express concern

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[68] SWRRG Comments at 9; WUTC Comments at 9-10.

[69] MCI Comments at 52-56.

[70] Ad Hoc Comments at 24-25; MCI Reply at 37.

[71] MCI Comments at 55-56.

[72] MCI Comments at 42-45.

[73] McGRaw Comments at 11; Alarm Industry Comments at 6-8; IDCMA Comments at 11-12; CompuServe Comments at 26-27; Messagephone Comments at 10; MCI Comments at 61-63; DC PSC Comments at 19-20; WUTC Comments at 9 (true for state regulators as well).

[74] MCI Reply at 38-39.

that cross-subsidies and other pricing improprieties could go undetected indefinitely or could be discovered only after damage to the competitive marketplace has occurred.[76] Ad Hoc claims that the Commission's affiliate trasaction rules do not permit the Commission effectively to detect abuses because actual affiliate transactions are not separately reported.[77] Parties who claim that cost allocation rules cannot protect against cross-subsidy also generally disagree with the *Notice's* observation that adoption of incentive regulation for the LECs reduces BOC incentives to cross-subsidize.

44. Many parties, including DOJ and NTIA, strongly support use of accounting safeguards to protect against cross-subsidization.[78] These parties state that the BOCs have provided nonregulated services for many years and have not been able to establish market dominance in any of the unregulated markets in which they compete, or harm consumers by raising regulated rates.[79] In addition, these parties note that the Ninth Circuit did not have the benefit of

[75] MCI Reply at 32-35; IDCMA Reply at 3-4.

[76] ANPA Comments at 19; CBEMA Comments at 5-6; IDCMA Comments at 13-14; Iowa Network Services Comments at 13-14; MCI Comments at 59-60; WUTC Comments at 9.

[77] Ad Hoc Comments at 23. Ad Hoc also contends that the affiliate transaction rules should encompass services. *Id.* at 23-24.

[78] NTIA Comments at 5, 8-10; DOJ Comments at 4-7; CSE Foundation Comments at 7-8; CBT Comments at 2-3; NYNEX Comments at 21-32; SNET Comments at 3-5; Pacific Comments at 32; Bell Atlantic Reply at 4; USTA Comments at 2-4; US West Comments at 99; Vermont State DPSC Comments at 1; Illinois CC at 6-7.

[79] CSE Foundation Comments at 7. According to Bell Atlantic and SWBT, the BOCs have only a 10% market share in the CPE market, indicating that BOC entry into competitive markets has not discouraged competition. Bell Atlantic Reply at 4-7; SWBT Reply at 37-38.

the record established in the *Joint Cost Proceeding*, and thus there was little evidence showing that effective cost accounting rules could in fact be developed and implemented. NTIA, DOJ, and others, including the BOCs, state that since adoption of the *Computer III* decision, the Commission has devised and implemented a comprehensive and viable set of cost accounting safeguards to protect against cross-subsidization, including cost allocation rules, cost allocation manual [7591] filings, independent audit requirements, ARMIS submissions, and on-site field audits.[80]

45. Parties supporting use of cost accounting rules also contend that the manner in which the Commission devised the cost allocation and affiliate transaction rules actually benefits regulated ratepayers.[81] Moreover, these parties argue that nearly four years of Commission and industry experience with these rules demonstrate that cost accounting safeguards can and do control the ability of the BOCs to cross-subsidize such that the benefits of replacing structural separation with nonstructural safeguards outweighs the potential costs.[82] Furthermore, these commenters state that LEC price cap regulation substantially reduces BOC incentives to cross-subsidize because the BOCs

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[80] Pacific Comments at 32-33; US West Comments at 99-100; Bell Atlantic Reply at 8.

[81] CSE Foundation Comments at 8; NYNEX Comments at 25-26; US West Comments at 100-101; Rochester Comments at 7, n. 16; Pacific Reply at 16; SWBT Comments at 28.

[82] NTIA Comments at 10; NYNEX Comments at 21-23; Pacific Comments at 32; Bell Atlantic Reply at 4.

cannot automatically pass on to ratepayers increases in costs.[83]

b. Discussion

46. We conclude that our comprehensive system of cost accounting safeguards has worked well and, as strengthened above, effectively protects ratepayers against cross-subsidization by the BOCs. This system consists of five principal parts: (1) the establishment of effective accounting rules and cost allocation standards; (2) the requirement for telecommunications carriers to file cost allocation manuals reflecting the established rules and standards; (3) the requirement for audits by independent auditors of carrier cost allocations, requiring a positive opinion on whether carriers' allocations comply with their cost allocation manuals; (4) the establishment of detailed reporting requirements and the development of an automated system to store and analyze the data; and (5) the performance of on-site audits by FCC staff.

47. The Uniform System of Accounts (USOA) prescribed by the Commission establishes the regulated accounts that carriers must use. After nearly fifty years without significant modification, the Commission substantially revised the USOA, effective January 1, 1988, to reflect [7592] significant changes in the industry and modern accounting practices.[84] In the *Joint Cost Proceeding*, the Commission adopted joint cost rules to ensure that

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[83] CSE Foundation Comments at 8-9; NYNEX Comments at 32; Rochester Comments at 7; SNET Comments at 6-7; SWBT Comments at 21-22; Pacific Reply at 24-25.

[84] Revision of the Uniform System of Accounts and Financial Reporting Requirements for Class A and Class B Telephone Companies, 51 Fed. Reg. 43,498 (December 2, 1986).

carriers are not permitted to assign the costs of nonregulated activities to the provision of regulated services. Under the Commission's cost allocation rules, costs are directly assigned to regulated or nonregulated activities whenever possible. In the event that costs cannot be directly assigned, costs are assigned, if possible, to regulated or nonregulated activities based on cost causation principles. Remaining costs are then allocated according to general allocation factors.

48. Moreover, these specific standards and rules are geared to protecting ratepayer interests. The Commission could have decided to adopt an incremental costing approach for nonregulated activities, which is likely to have encouraged faster and more extensive development and deployment of enhanced services by telecommunications common carriers. Instead, the Commission employed a fully distributed cost (FDC) allocation methodology. Under this methodology, nonregulated services must contribute towards the general overhead costs of the regulated operations, which would otherwise be borne entirely by the ratepayers of regulated services. Thus, an FDC approach assures that ratepayers will receive additional protection and benefit from the efficiencies gained through joint use of the network. The Commission also adopted affiliate transaction rules that prevent the BOCs from charging ratepayers inflated prices for goods and services obtained from nonregulated affiliates, or from providing these affiliates with goods and services at unduly low prices.[85] Additionally, the requirement that enhanced

[85] 47 C.F.R. §32.27. Similarly, the affiliate transaction rules are geared to protecting ratepayers. According to those rules, asset transfers from regulated accounts are recorded by the BOCs at net book cost or fair market value, whichever is higher, while assets transferred from a nonregulated affiliate to a regulated

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services costs be excluded from separations will help assure that such costs are excluded from the interstate ratemaking process.[86]

[7593] 49. As the second part of our system, the Commission has reviewed and approved BOC cost allocation manuals showing the cost allocation factors used to allocate joint costs and the manner in which the BOCs will implement cost allocations. The manuals provide detail on the nature of nonregulated activities and the cost accounts they affect, as well as cost allocation formulas and procedures. All the original cost allocation manuals were subject to public comment and Commission review. Before their

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carrier are recorded at the lower of net book cost or fair market value. These rules also cover the transfer of services to and from unregulated affiliates and regulated carriers in a manner that properly allocates costs to the appropriate activity. For services that are provided to or received from affiliates, the rules require that the affiliate pay the tariff rate or, if there is no tariff rate, the prevailing price (determined by transactions with nonaffiliates), or fully distributed cost. By structuring our affiliate transaction rules this way, the nonregulated activity bears not just its incremental costs for asset and service transfers but general overhead costs as well, which would otherwise be solely borne by regulated ratepayers.

[86] By excluding enhanced services from separations, the Commission can directly ensure that interstate basic service ratepayers do not bear the costs of unregulated services. Our cost allocation safeguards also provide sufficient information for the states to protect against cross-subsidies at the intrastate level. The operation of the joint cost and separations rules results in a BOC intrastate assignment of basic services costs. To protect against cross-subsidy of enhanced services by intrastate ratepayers, a state need only use its normal regulatory mechanisms to ensure that intrastate rates are not too high in light of that assignment.

original approval, the Commission required extensive revisions to the BOCs' cost allocation manuals.[87] Under the strengthened cost accounting safeguards adopted today, the BOCs will be required to quantify the effects of cost allocation manual changes in $100,000 increments at the cost pool level for cost apportionment changes and at the account level for changes in time reporting and affiliate transactions. This level of detail will improve the ability of staff and the public to evaluate proposed cost allocation manual changes. Additionally, as indicated, the Common Carrier Bureau is undertaking an examination of ways to achieve even greater uniformity in cost allocation manuals than currently exists, which could further enhance comparisons of BOC manuals.

50. We have also required that the BOCs submit to annual audits conducted by independent auditors. The independent audit requirement has proven to be a very useful and cost effective tool in reviewing implementation of the carriers' cost allocation manuals and the results of cost allocations under the manuals. The requirement also assists Commission staff in evaluating carriers' compliance with the Commission's rules, as well as the effectiveness of the rules themselves. As strengthened by our action in this Order, independent auditors are required to provide the same level of assurance in their audits as that undertaken in a financial statement audit engagement. Under this level of assurance, the auditor will provide an opinion on the carrier's cost allocations in light of the requirements of the cost allocation manual approved by the Commission as

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[87] *See* NYNEX Comments at 27; SWBT Comments at 29-30; NYNEX Reply at 15.

well as of our joint cost rules and other pertinent regulations. Commission auditors continually review the audits submitted by the independent auditors.

51. The Commission also has imposed detailed reporting requirements for the BOCs' cost allocations and has developed and implemented ARMIS, an automated system to store and analyze the reported data. The ARMIS system contains detailed cost and revenue information that allows the Commission to make benchmark comparisons among the carriers and across time periods to identify discrepancies warranting Commission attention. In the [7594] *ARMIS Order*,[88] the Commission required carriers to file new computerized reports aimed at detecting improper cross-shifting. These reports are available to the states and to the public. The quarterly report contains certain financial data reflecting the results of the accounting and cost allocation requirements prescribed in Part 32 and Part 64 of the Commission's Rules.[89] Also, carriers are required to file an annual USOA Report displaying the results of their total activities for every account in the USOA, and an annual Joint Cost Report showing the allocation to regulated and nonregulated activities for all accounts involved in the ratemaking process. Over time, the Commission has refined the ARMIS reporting requirements in order to make benchmark comparisons more easily and readily available.

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[88] *See* note 12, *supra*.

[89] Part 32 contains the USOA, which lists the more than 250 accounts used by the carriers to record the costs and revenues of their regulated and nonregulated activities. Part 64 contains the rules adopted in the *Joint Cost Order* that separate regulated costs from the costs of nonregulated activities.

52. Commission staff also conducts targeted on-site audits. These audits determine whether specific carrier practices and procedures are in compliance with the joint cost rules and whether such practices and procedures are sufficient to prevent cross-subsidization. The Commission examines, among other things, carrier procedures and practices that may be found to be potentially vulnerable to cross-subsidization. In preparation for on-site audits, Commission staff scrutinizes the independent audit reports, the detailed ARMIS submissions, complaints against the carriers, cost allocation manual filings, and internal analytical studies. These efforts permit the Commission to target on-site audits effectively on those carriers and those issues that most warrant Commission attention. Commission auditors, among other things, interview witnesses, study thousands of pages of workpapers, and review the carriers' own internal control systems designed to prevent cross-subsidy.

53. We are not persuaded by commenters who claim that these requirements and procedures will be inadequate to detect improper cross-subsidization. While allocation factors and the detailed manner of implementaion of allocations are chosen by the BOCs, we have established specific guidelines and reporting mechanisms for the BOCs to follow and, as has been done in the past, we will not hesitate to require changes in cost allocations when necessary. We conclude that our comprehensive system of accounting safeguards provide a reasonable and sufficient method of assuring that the cost allocation factors chosen by the BOCs and the manner of implementing the cost allocations set forth in the cost allocation manuals will not result in cross-subsidy.

Similarly, MCI's claim that the BOCs [7595] routinely overproject regulated costs is completely unsupported.[90] Accordingly, we reject arguments of commenters that our cost allocation requirements are so vague as to permit carriers to engage in cross subsidization.[91]

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[90] Moreover, under our joint cost rules, the BOCs are constrained from overallocating joint costs to the regulated side. If actual nonregulated usage does exceed projected peak usage, a reallocation of investment is required to the nonregulated side. The reallocation compensates the regulated operation for the time value of the costs it bore for the nonregulated operation. It also blunts any incentive for the BOCs to underestimate its future nonregulated demand with the goal of overallocating investment to the regulated operations.

[91] Nor are our rules defective because they fail to charge nonregulated operations for training when, for example, regulated service employees go to work for the nonregulated service operations. *See* MCI Comments at 10. Even under a structural separation requirement, a BOC employee could be trained by the regulated company and then subsequently transferred to the BOCs' nonregulated affiliate. In addition, the joint cost rules already address the question of "inter-temporal cross-subsidies" raised by Ad Hoc. *See* Ad Hoc Comments, Attachment at 12. In the *Joint Cost Proceeding*, we did not adopt a costing methodology that would have allocated the costs of regulated services (central office equipment and outside plant investment) between regulated and nonregulated services based on actual relative regulated and nonregulated use, but rather on the basis of intended relative use. The Commission adopted a projected use methodology to ensure that ratepayers do not bear the risks and costs of nonregulated business failures. For instance, if a cost were incurred largely to provide for future nonregulated services, and these services failed to grow as expected, we did not want regulated ratepayers to pay for the nonregulated share of the costs. *Joint Cost Order*, 2 FCC Rcd at 1320, paras. 169-172.

54. Based on nearly four years experience with cost accounting safeguards, we are convinced that we will be able to continue to enforce these safeguards. Underlying information, including the time reporting of employees, is subject to audit both by independent auditors and Commission staff. Furthermore, ARMIS contains detailed reporting of the cost allocations that can be used to evaluate an individual BOC's actual allocations of costs as well as to make benchmark comparisons between the BOCs. MCI's claims that these reports do not reveal subtle cross-subsidies is unsupported and unexplained. The Commission has refined the ARMIS requirements to facilitate meaningful benchmark comparisons. The Commission also has adequate resources to monitor the BOCs' activities.[92] Contrary to the view of some commenters, our enforcement action against the NYNEX telephone companies for apparently improper affiliate transactions between New York Telephone and New England Telephone, and NYNEX's nonregulated [7596] affiliate, the Material Enterprises Company (MECO) supports the efficacy of our affiliate transaction rules.[93]

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[92] We will also work with Congress to secure additional resources if they become necessary.

[93] Based on a Common Carrier Bureau audit, we tentatively concluded that MECO had overcharged its telephone company affiliates by a total of $118.5 million from 1984 through 1988. Accordingly, this Commission ordered New York Telephone and New England Telephone to show cause why they should not be required to remove $32.6 million in excessive capital costs from their rate base, and perform ratemaking adjustments to return $35.5 million in improper charges imposed on interstate ratepayers. This Commission also found the two telephone companies apparently liable for forfeiture totaling $1.419 million

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55. We also conclude that the implementation of the LEC price cap regulation as of January 1, 1991, is a significant regulatory development since the *BOC Separation Order* that reduces BOC incentives to cross-subsidize enhanced services with basic services.[94] Under rate-of-return regulation, a regulated carrier is entitled to charge basic service rates that reflect regulated costs plus a reasonable rate of return on investment. As a practical matter, misallocation of nonregulated costs to regulated operations under rate-of-return regulation increases a carrier's regulated costs and therefore permits higher regulated rates to recover the improperly allocated nonregulated costs. By contrast, because price cap

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for violation of the Commission rules. *See* New York Telephone Co. and New England Telephone and Telegraph Co., Apparent Violations of the Commission's Rules and Policies Governing Transactions with Affiliates, *Order to Show Cause and Notice of Apparent Liability for Forfeitures*, 5 FCC Rcd 866, 870-871, paras. 31, 33 (1990). New York Telephone and New England telephone denied any allegations of wrongdoing. A consent decree was entered into on October 3, 1990, in which NYNEX agreed to reduce its interstate capital account balances by $32.6 million, to reduce interstate revenue requirements by $35.5 million, and to make contributions to the United States Treasury in the amount of $1.419 million. *See* New York Telephone Co. and New England Telephone and Telegraph Co., *Apparent Violations of the Commission's Rules and Policies Governing Transactions with Affiliates*, 5 FCC Rcd 5892 (1990), *recon. denied*, 6 FCC Rcd 3303 (1991), *appeals pending sub. nom.*, New York v. FCC, No. 91-1362 (D.C. Cir. filed August 5, 1991). Having obtained for interstate ratepayers and the Treasury all of the relief sought in the *Order to Show Cause*, we agreed to terminate the proceeding without a finding of wrongdoing on the part of NYNEX.

[94] *See* CSE Foundation Comments at 9; NYNEX Comments at 32; Rochester Comments at 7; SNET Comments at 6-7; SWBT Comments at 21; Pacific Reply at 24-25.

regulation severs the direct link between regulated costs and prices, a carrier is not able automatically to recoup misallocated nonregulated costs by raising basic service rates, thus reducing the incentive for the BOCs to shift nonregulated costs to regulated services.[95]

[7597] 56. The Court in *California v. FCC* vacated *Computer III* in its entirety because the Court concluded that the Commission had not presented a sufficient justification for reliance on cost accounting safeguards so soon after its decision in the *BOC Separation Order* to continue structural separation for BOC enhanced services operations. Based on our experience of nearly four years, and based on the record developed on remand, we conclude that our cost accounting safeguards constitute a realistic and reliable alternative to structural separation to protect against cross-subsidy. We find as well that the

[95] *See* NYNEX Comments at 32; Rochester Comments at 7; SNET Comments at 6-7; SWBT Comments at 21; Pacific Reply at 24-25. Several parties claim that the BOCs have an incentive, pending the price cap review of the productivity offset in 1994, to load up their regulated operations with additional costs in order to avoid an increase in their productivity offset. *See, e.g.*, MCI Comments at 24; DC PSC Comments at 23-24. Furthermore, as recognized in the *Notice*, there may be some incentive remaining under price cap regulation for LECs whose earnings are approaching the sharing mark to try to shift costs to the regulated side of its operations. *See* Ad Hoc Comments at 22. We do not find here that LEC price cap regulation eliminates all possible incentive to shift costs. We find, rather, that these incentives under price caps are much less significant than under rate-of-return regulations, for the BOCs are no longer automatically entitled to increase rates to recoup cost increases. LEC price cap regulation serves as an effective complement to cost accounting, reporting, auditing, and enforcement safeguards.

adoption and implementation of incentive regulation for the BOCs serves as an effective complement to these cost accounting safeguards by reducing BOC incentives to cross-subsidize their enhanced services. We further conclude that the effectiveness of those nonstructural safeguards renders any costs of eliminating structural separation marginal.

B. *Safeguards Against Discrimination*

57. The *Notice* proposed the following nonstructural safeguards to protect independent ESPs from possible BOC discrimination in the provision of access to underlying basic services: (1) ONA, as adopted by the Commission in December 1990; (2) the *Computer III* nondiscrimination reporting requirements; (3) *Computer III* network information disclosure rules; and (4) CPNI disclosure rules. The *Notice* proposed to rely on ONA, which the Commission readopted at the time of the *Notice*. The *Notice* also proposed to adopt the *Computer III* nondiscrimination reporting requirements and network information disclosure rules, and requested comment on whether we should modify the CPNI rules. Finally, the Commission proposed, irrespective of its broader decisions regarding structural and nonstructural safeguards, to eliminate both the capitalization plan requirement and the prohibition against a regulated BOC and a BOC affiliate from performing software development for one another.

58. In this *Report and Order*, we conclude that a set of nonstructural safeguards will effectively protect against potential discrimination by the BOCs in provision of basic services to competing ESPs. Contrary to the requests of some commenters,

fundamental changes in our ONA requirements are not necessary in order to rely on them for protection against discrimination. We readopt the *Computer III* nondiscrimination [7598] reporting requirements as effective protections against discrimination in quality, and in installation and maintenance of basic services. We also readopt the *Computer III* network disclosure rules to assure that competing ESPs obtain critical network information in a timely fashion. We adopt modified CPNI requirements that require BOC enhanced services marketing personnel to obtain prior authorization before accessing the CPNI of customers with more than twenty lines. These safeguards, along with nonstructural safeguards against cross-subsidization, should effectively protect against anticompetitive conduct by the BOCs toward competing ESPs. We also eliminate the capitalization plan requirement and the prohibition against a BOC and unregulated affiliates performing software development for one another.

1. *Open Network Architecture*

59. *Background.* The *Phase I Order* in *Computer III* adopted CEI requirements so that unaffiliated ESPs could obtain nondiscriminatory access to the underlying basic network services used by the BOCs in their provision of enhanced services. Under CEI, the BOCs were required to provide their ESP competitors with "equal access" interconnections to basic network services at the same tariffed rates that the BOCs themselves paid.[98] The

[98] Basic services used in the provision of BOC enhanced services had to "be available to others on an unbundled basis, with technical specifications, functional capabilities, and other quality and operational characteristics, such as installation and maintenance times, equal to those provided to the carrier's enhanced services." *Phase I Order*, at 1036-1037, paras. 147, 150, n. 210.

Commission also required that the BOCs implement ONA, which extended CEI principles beyond the underlying services used to provide their own enhanced services to the BOCs' overall basic networks and which was designed to increase opportunities for ESPs to use the regulated networks of the BOCs in a nondiscriminatory manner. Under ONA, the BOCs were required to develop plans describing how they would provide unbundled basic service "building blocks," so that competing ESPs could use network services in a flexible and economical manner. Specifically, we required the BOCs to make available basic services, features, and functions requested by ESPs, based on the expected market demand for such elements, their utility as perceived by enhanced service competitors, and the technical and costing feasibility of such unbundling.[97]

60. Following the Ninth Circuit's vacation and remand of *Computer III*, we proposed to reinstate ONA, which had not been challenged before the [7599] Ninth Circuit.[98] At the time we adopted the *Notice* on this proceeding, we also adopted an Order requiring the BOCs to implement ONA.[99]

61. *Comments.* A few parties argue that ONA will not be an effective safeguard against BOC access discrimination.[100] These parties argue that competing

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[97] *Phase I Order*, 104 FCC 2d at 1065-1066, paras. 214, 217.

[98] Computer III Remand Proceedings, CC Docket No. 90-368, *Notice of Proposed Rulemaking*, 5 FCC Rcd 5242 (1990).

[99] Computer III Remand Proceedings, CC Docket No. 90-368, *Report and Order*, 5 FCC Rcd 7719 (1990).

[100] MessagePhone Comments at 11; ANPA Comments at 25; MCI Comments at 77; Ad Hoc Comments at 25.

ESPs will never achieve access to the network comparable to that of the BOCs' enhanced services because ONA does not require the BOCs to allow independent ESPs to collocate their equipment at BOC central offices or require the BOCs to unbundle transport and switching.[101] Also, some parties assert that ONA is just a repackaging of limited network services that were in existence and being offered prior to the development of ONA, and that the BOCs are reluctant to unbundle network offerings any further.[102] MCI claims that the BOCs' ONA plans do not contain proposals to deploy any new or improved unbundled types of ONA services.

62. *Discussion.* We conclude that ONA constitutes an effective safeguard, helping to ensure that independent ESPs obtain nondiscriminatory access to BOC basic services. The *California* Court did not criticize ONA, but stated that the record supported the Commission's findings that ONA "will be effective in reducing the risk of BOC access discrimination[.]"[103] Our experience with ONA since that time serves to reaffirm this conclusion. ONA has been developed in a meticulous fashion over the past five years. In particular, the BOCs were required to file detailed ONA plans in 1988, specifying the basic services they would provide to competing ESPs and the time of deployment, as well as the methods employed to comply with our other nondiscrimination safeguards. These ONA plans were subject to intense scrutiny by both the public and the Commission. In December 1988, the Commission released an order

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[101] Ad Hoc Comments at 25-26; ANPA Comments at 25.

[102] ANPA Comments at 25; MCI Comments at 71-72.

[103] *California*, 905 F.2d at 1238.

that approved the BOC ONA plans in substantial part but identified a number of areas that needed revision before ONA could be effectively implemented. In May, 1989, the BOCs filed amended ONA plans, which were again subject to public comment and careful review. In May 1990, we approved the amended plans, and authorized implementation of ONA. To ensure the continued evolution of ONA, the Commission required further amendments to the ONA plans, which were filed in April 1991, and are addressed in a companion order. On November 1, 1991, the BOCs filed federal tariffs for their initial ONA services.

[7600] 63. We conclude that, given current network architecture and technical capabilities, the BOCs are generally meeting the basic service needs of the enhanced services industry. Since the filing of the original ONA plans, the BOCs have filed tariffs for initial ONA services. NYNEX alone has filed tariffs for twenty-one ONA services in response to request by independent ESPs.[104] The BOCs' ONA plans describe in considerable detail their deployment plans for new ONA services, and the BOCs are continually introducing new ONA services that will be offered to ESPs.[105]

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[104] According to NYNEX, only two of these services are utilized in conjunction with NYNEX's enhanced service offerings. NYNEX Reply at 44-45.

[105] In a companion order, we today generally approve the BOCs' most recent ONA plan amendments detailing their provision of ONA services. *See* Filing and Review of Open Network Architecture Plans, CC Docket No. 88-2, Phase I, FCC 91-382 (released December 19, 1991). To the extent that parties argue that the CEI rules do not allow independent ESPs to purchase

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64. We are not persuaded by the conclusory arguments of some commenters that we need make fundamental changes in ONA in order to rely on it as a check against discrimination. Mandatory physical collocation of ESP equipment is not necesssary to ensure comparable access. The *Phase I Order* sets forth nine parameters designed to ensure comparable technical access,[106] and the Commission has approved BOC parity pricing as satisfactorily providing comparable pricing.[107] In the *BOC ONA Order*, the Commission declined to require a radical reconfiguration of fundamental unbundling of the BOC networks, stating that providing ONA based on a more disaggregated, [7601] and at that time unspecified, architecture would be extremely costly and unnecessary for effective implementation of ONA.[108]

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different or more advanced basic network services than those used in the provision of BOC enhanced services, *see, e.g.*, Accessplus Comments at 9, these parties confuse our CEI and ONA requirements. As discussed above, the CEI regime was a transitional phase that provided ESPs with "equal access" to the underlying basic services used to provide BOC enhanced services. Reasonable access to different or new basic services desired by ESPs, however, is a requirement of ONA.

[106] The CEI parameters include: (1) interface functionality; (2) basic service unbundling; (3) resale; (4) technical characteristics; (5) installation, maintenance, and repair; (6) end user access; (7) CEI availability; (8) minimization of transport costs; and (9) CEI recipients. *See Phase I Order*, at 1021-1043, paras. 117-166. The ONA plans filed by the BOCs contain considerable detail on how the BOCs are to satisfy these parameters.

[107] *Phase II Order*, 104 FCC 2d at 10489-1049, paras. 174-175; *Phase I Second Further Reconsideration Order*, 4 FCC Rcd at 5927-5929, paras. 3-19.

[108] *BOC ONA Order*, 4 FCC Rcd at 41-43, paras. 69-72. We note that we are actively considering the public interest benefits of

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2. *Nondiscrimination Reporting Requirements*

65. *Background.* In the *Phase II Order*, the Commission required the BOCs to file quarterly

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unbundling switching and transport in our *Expanded Interconnection* proceeding. Expanded Interconnection with Local Telephone Company Facilities, CC Docket No. 91-141, Notice of Proposed Rulemaking and Notice of Inquiry, 6 FCC Rcd 4818 (1990).

The *Notice* also requested comment on the relationship between the nondiscrimination safeguards and LEC price cap regulation. *Notice*, 6 FCC Rcd at 180, para. 37. Only two parties discussed this issue. MCI stated that application of price cap regulation to ONA pricing would allow rate churn, making it difficult for ESPs to plan ahead in developing their own enhanced services. MCI Comments at 84. Furthermore, the DC PSC contends that price cap regulation may give the BOCs flexibility to price basic service elements (BSEs) that they use for their own enhanced services at lower rates than BSEs that they do not use. DC PSC Comments at 28-29. The Commission addressed these concerns in the *Part 69/ONA Order*, where we adopted a cost-based approach to the initial pricing of new ONA services, such as BSEs and basic services arrangements (BSAs). Under this approach, a LEC introducing new services must satisfy the net revenue test as well as submit, for example, engineering studies, time and wage studies, and other cost accounting studies to identify the direct costs of providing the new service. In addition, the BOCs were required to "flag" or identify the BSEs that they intend to use in their enhanced service operations. This requirement was adopted in order to prevent the BOCs from discriminating against independent ESPs by raising the rates of BSEs that their competitors use and decreasing the rates of BSEs that their own enhanced service operations use. *See* Amendments of Part 69 of the Commission's Rules Relating to the Creation of Access Charge Subelements for Open Network Architecture and Policy and Rules Concerning Rates for Dominant Carriers, CC Docket Nos. 89-79 and 87-313, Report and Order & Order on Further Reconsideration & Supplemental Notice of Proposed Rulemaking, 6 FCC Rcd 4524, 4528, 4531-4533, paras. 23, 38-50.

nondiscrimination reports.[109] Subsequently, the Commission required the BOCs to use a uniform format for their reports on the installation and maintenance of basic services and specified 48 basic service categories for reporting.[110] The Commission also modified the quality reporting requirement and required the BOCs to file annual affidavits [7602] attesting that they have not discriminated in the quality of services provided to enhanced service competitors.[111]

66. *Comments.* MCI argues that the nondiscrimination reporting requirements are no stronger than they were under structural separation, and that, absent a change in regulatory or market conditions, these requirements must be strengthened under nonstructural safeguards.[112] MCI and ADAPSO argue that the effectiveness of this safeguard relies on compliance by BOC employees and after-the-fact reporting, which is too arbitrary.[113]

67. *Discussion.* We conclude that our nondiscrimination reporting requirements adequately protect ESP competitors from discrimination in the installation, maintenance, and quality of basic services. The nondiscrimination reporting

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[109] *See Phase II Order,* 2 FCC Rcd at 3082, 3084, paras. 73, 89.

[110] *BOC ONA Reconsideration Order,* 5 FCC Rcd at 3103, paras. 76-80.

[111] Filing and Review of Open Network Architecture Plans, CC Docket No. 88-2, Phase I, 4 FCC Rcd 1, 248-249, para. 481 (*BOC ONA Order*); 5 FCC Rcd 3084 (1990) (*BOC ONA Reconsideration Order*); 5 FCC Rcd 3103, 3120, para. 145 (*BOC ONA Amended Plans Order*). *See also Phase II Reconsideration Order,* 3 FCC Rcd at 1160, paras. 76-77.

[112] MCI Comments at 82-83.

[113] ADAPSO Comments at 12-15; MCI Comments at 86-88.

requirements were adopted to protect against possible discrimination against ESPs by the BOCs in the quality, and installation and maintenance, of basic services. These requirements are designed so that the Commission can compare the level of service of basic services used in providing the BOCs' enhanced services with that of services used by their enhanced service competitors. During the past three years, we have reviewed the installation and maintenance reports filed by the BOCs. These reports indicate that the BOCs are installing and maintaining the basic services used in providing their own enhanced services in the same fashion and at the same rate as the basic services used by their competitors. We note that we have not received any complaints alleging that the BOCs are discriminating in the installation, maintenance, or quality of basic services. MCI does not point to any specific reasons as to why our nondiscrimination reporting requirements are ineffective. Based on our experience, we find that, within the ONA framework that the Commission has developed, they adequately protect against discrimination in the installation, maintenance, repair, and quality of basic services. We therefore readopt the nondiscrimination reporting requirements in effect before the *California* decision.[114]

3. *Network Disclosure Rules*

68. *Background.* In *Computer III* the Commission adopted network information disclosure rules to ensure that independent ESPs receive timely

[114] This includes the requirement that the BOCs file annual affidavits attesting that they have not discriminated in the quality of services provided to their enhanced service competitors.

[7603] access to technical information related to new or modified network services affecting the interconnection of enhanced services to the BOC networks.[115] These rules require that disclosure of network information to ESPs occur at the make/buy point, *i.e.*, when the carrier decides to make itself, or to procure from an affiliated entity, any product the design of which relies on the network interface. The BOCs were also required to release this information publicly at least twelve months prior to the introduction of the new service or network change. If a carrier was able to introduce the service between six and twelve months after the make/buy point, however, public disclosure was required at the make/buy point, but not less than six months before the introduction of the service.[116]

69. *Comments.* MCI argues that the network information disclosure requirement is no stronger than that under structural separation.[117] IDCMA further argues that these rules actually advantage the BOCs in their provision of enhanced services operations because public disclosure of network information is not required at the time the information is actually given to the BOCs' unregulated services personnel but, rather, at the make/buy point, which may be substantially later. [118] Several parties, including DOJ, NTIA, the Michigan PSC, and the Illinois Commerce Commission, support

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[115] *Phase I Order*, 104 FCC 2d at 1080-1086, paras. 246-255.

[116] *See Phase II Order*, 2 FCC Rcd at 3087-3088, paras. 107-112.

[117] MCI Comments at 82-83.

[118] IDCMA Comments at 19, n. 25.

readoption of the network information disclosure rules.[119]

70. *Discussion.* We conclude that the *Computer III* network disclosure rules provide the enhanced services industry with critical network information in a timely fashion, and thus serve as an effective safeguard against discrimination in the provision of basic services to competing ESPs. These rules generally require disclosure to independent ESPs at the make/buy point, which includes the time when the BOCs begin joint planning, research, or development of enhanced services that require new network services or changes to existing network services that affect the interconnection of enhanced services with the network.[120] Furthermore, any decision by the BOCs to manufacture or procure hardware or software for any service relying on the new or modified network interface would also trigger our disclosure requirements. We did not require disclosure to ESPs as soon as BOC personnel with any involvement with enhanced services are provided with network information. Such a disclosure rule would impair the carriers' development efforts, inhibit network improvements, and eliminate the benefits of removing [7604] structural separation by reinstituting the same types of artificial and inefficient restraints on internal information flows that are imposed by structural separation requirement.[121] Such early

[119] NYNEX Comments at 83-84; Ameritech Comments at 22-23; Pacific Comments at 70; Michigan PSC Comments at 9-10, Illinois CC Comments at 5-6; NTIA Comments at 5-6; DOJ Comments at 7.

[120] *Phase I Order,* 104 FCC 2d at 1081, para. 252.

[121] *Phase I Order,* 104 FCC 2d at 1081, 1083-1084, paras. 248, 251-252. The same rules have also worked well when applied to the provision by the BOCs of basic services and unregulated

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disclosure of possible changes in the network could also cause significant difficulties if a BOC subsequently chose to follow a different course, giving rise to possible allegations of misconduct by ESPs who have relied on such preliminary information.[122] Again, MCI does not provide any specific reasons as to why the network disclosure rules are inadequate. Accordingly, we readopt the network disclosure rules in effect prior to the *California* decision.

4. *Capitalization Plan Requirement and Software Development*

71. *Background.* In *Computer II*, the Commission required the BOCs to file capitalization plans regarding the capital structure of the nonregulated affiliate.[123] The Commission eliminated

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customer premises equipment. *See* Furnishing of Customer Premises Equipment by Bell Operating Telephone Companies and the Independent Telephone Companies, Report and Order, 2 FCC Rcd 143 (1987) (*BOC CPE Relief Order*), *mod'd on recon.*, 3 FCC Rcd 22 (1987) (*Reconsideration Order*).

[122] The State of Hawaii argues the GTE should be subject to the same nondiscrimination safeguards as are the BOCs because GTE is comparable to the BOCs and because Hawaii is served only by one carrier, GTE. Hawaii Comments at 3-8. GTE contends that it is not comparable to the BOCs in that it is comprised of a number of geographically dispersed LECs and that it is voluntarily complying in some respects with ONA and nondiscrimination safeguards. GTE Reply at 1-9; *Ex Parte* Letter, from Whitney Hatch, Assistant Vice President, Regulatory Affairs, GTE, to Donna R. Searcy, Secretary, FCC, November 12, 1991. Although this is an issue worthy of Commission consideration, it is beyond the scope of this proceeding to determine whether GTE should be subject to the same nondiscrimination requirements as the BOCs for GTE's provision of enhanced services.

[123] *Final Decision*, 77 FCC 2d at 485, para. 258.

the capitalization plan requirement in *Computer III*.[124] The Commission also in *Computer II* prohibited the regulated BOC company and its nonregulated affiliate from performing software development for one another.

72. *Comments.* No parties opposed the proposal in the Notice to eliminate the capitaliztion plan requirement or the prohibition against joint software development. On the other hand, several commenters express support for the removal of the capitalization plan requirement and the [7605] prohibition against the regulated company and the nonregulated affiliate from performing software development for one another.[125]

73. *Discussion.* We conclude that, in light of the implementation of our affiliate transaction rules and the burdens associated with the capitalization plan requirement, the filing of capitalization plans is no longer justified. We have no indication that the BOCs have improperly transferred assets from the regulated company to the separate subsidiary. Moreover, since *Computer II,* the Commission has implemented affiliate transaction rules that include asset valuation requirements to govern the transfer of assets to and from regulated and nonregulated affiliates. These rules specifically address the concerns mentioned in *Computer II* that resulted in the capitalization plan requirement. Under the affiliate transaction rules, asset transfers from the regulated company are recorded by the BOCs at net book cost or fair market value, whichever is higher.

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[124] *See Phase I Order,* 104 FCC 2d at 1076-1077, paras. 238-240; *Phase II Order,* 2 FCC Rcd at 3098-3099, paras. 177-186.

[125] *See e.g.,* Pacific Comments at 70-71.

Thus, improper subsidies in the form of asset transfers will not flow from regulated ratepayer pockets to any separate nonregulated affiliate.

74. Similarly, we eliminate the prohibition against the BOCs' regulated company and any nonregulated affiliates performing software development for one another. The Commission's affiliate transaction rules specifically govern joint software development, and will adequately protect ratepayers from any disproportionate spreading of the costs of software development onto regulated activities. Transfer of services from the regulated company to the nonregulated company require that the affiliate pay the tariff rate, the prevailing price (determined by transactions with nonaffiliates) if there is no tariff rate, or fully distributed cost. These rules ensure that the unregulated affiliate does not obtain special discounts or other improper price reductions to the detriment of regulated ratepayers.

C. *Customer Proprietary Network Information*

1. *Background*

75. Under the current CPNI rules for enhanced services, the BOCs' enhanced services marketing personnel are allowed to make use of CPNI without customer authorization, although a customer can request that its CPNI be withheld from such personnel. Independent ESPs, by contrast, must obtain advance authorization from the customer in order to obtain access to CPNI. The rules also require that the BOCs provide an annual written notice of CPNI rights to multiline business customers, and that any aggregated CPNI that a BOC makes available to

persons involved in the marketing of enhanced services must also be made available to independent ESPs on the same terms.

76. The current CPNI rules for enhanced services were adopted in the *Phase II Order,*[126] and reaffirmed in the *Phase II Reconsideration* [7606] *Order.*[127] In the *BOC ONA Reconsideration Order,*[128] however, the Commission noted the continued concerns of ESPs about the competitive effects of the rules, and recognized that the manner in which the rules are implemented may affect whether a customer purchases BOC enhanced services before becoming aware either that independent providers exist or that those providers may have access to the customer's CPNI to structure a service offering to meet the customer's needs. Although we concluded that the CPNI rules were not properly before us at that time, we directed the BOCs to address any legitimate concerns of the independent ESPs in the April 1991 amended CMA plans.

77. In the *Notice,* we decided to expand and accelerate our review of the CPNI safeguards applicable to BOC provision of enhanced services. We requested comment both on proposals for improving the implementation of the CPNI rules, and on modifications to the rules, including specifically a prior authorization requirement to be applied to the

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[126] *Phase II Order,* 2 FCC Rcd at 3093-3098, paras. 141-176.

[127] *Phase II Reconsideration Order,* 3 FCC Rcd at 1161-1164, paras. 85-114.

[128] *BOC ONA Reconsideration Order,* 5 FCC Rcd at 3094, paras. 81-83.

BOCs in some or all circumstances.[129] The *Notice* specified that any proposals should balance considerations of efficiency, competitive equity, and customer privacy.

2. *Comments*

78. Parties seeking modification of the current CPNI rules focus largely on the issue of competitive equity. Independent ESPs and others argue that the current CPNI rules give the BOCs a significant competitive advantage.[130] For instance, parties assert that the BOCs can use their access to CPNI: (1) to identify new customers before anyone else and to contact those customers before they realize that there are competitive alternatives; (2) to target the customers of competing ESPs; (3) to tailor their marketing presentations based on information about customers' network usage; and (4) to identify the appropriate customer contact.[131] Some parties argue in particular that the current rules give the BOCs the opportunity to try to sell enhanced services to customers who contact them to purchase basic [7607] services for use in conjunction with a competing

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[129] *Notice*, 5 FCC Rcd at 180, paras. 38-40.

[130] ADAPSO Comments at 35-36; ANPA Comments at 40-45; ATSI Comments at 10-16; ONA Users Group Comments at 6-9; CompuServe Comments at 32-33; Iowa Network Services Comments at 32-35; California Comments at 9-10; Colorado Comments at para 7; DC Public Service Commission Comments at 29; Florida Comments at 12-13; NARUC Comments at 15; New York Comments at 11-12; Pennsylvania Comments at 11-14; Sprint Comments at 3-4; IDCMA Comments at 18; MessagePhone Comments at 15; IIA Comments at 6-15.

[131] *See e.g.*, ANPA Comments at 40-42; ATSI Comments at 10-11; Iowa Network Services Comments at 32-35; IIA Comments at 6-15; Florida Comments at 12-13.

ESP's services.[132] Moreover, some parties contend that many customers do not understand, or simply ignore, the CPNI notices currently provided to multiline business customers, suggesting that these notices are an ineffective response to competitive concerns.[133]

79. Some ESPs argue specifically that the current rules do not provide sufficient protection for their own CPNI or that of their customers. For instance, ATSI asserts that although an ESP is permitted to restrict BOC access to its CPNI, the BOCs discourage restrictions by telling ESPs who do so that they can no longer do business with the account executives familiar with their business needs.[134] With regard to the CPNI of the ESPs' customers, Iowa Network Services proposes that the Commission prohibit the BOCs from releasing such CPNI to the BOC enhanced services operations without the consent of the ESP, in order to prevent the BOCs from identifying and marketing enhanced services to the ESPs' customers.[135] A number of large customers express concern over unrestricted BOC

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[132] ATSI Comments at 12-15.

[133] TCA Comments at 6-7. *See also* US West Comments at 72-75; Ameritech Comments at 27-28.

[134] ATSI Comments at 16-18. Pacific responds that under a prior authorization requirement, all customers that do not authorize access to CPNI will suffer the same inconvenience of which ATSI complains because these customers would need to be transferred from their current account executives to network-services-only account executives. Pacific Reply at 38-39. TCA argues that the BOCs should not only be subject to a prior authorization rule, but should also be prohibited from assigning enhanced service marketing functions to their network service account terms. TCA Comments at 7-8.

[135] Iowa Network Services Comments at 34.

access to CPNI, arguing that CPNI can be competitively sensitive from the customer's point of view.[136]

80. The BOCs respond to competitive equity arguments in a number of ways. The BOCs argue that CPNI does not provide them with a significant advantage in identifying customers.[137] Some of the BOCs also contend that CPNI cannot easily be used to generate lists of potential customers,[138] or that independent ESPs have access to much better marketing data from other sources, such as their own customer records or publicly sold marketing [7608] lists.[139] The BOCs also argue that CPNI has little value because ESPs make very few requests for CPNI.[140] Some of the BOCs assert that they have addressed certain ESP competitive equity concerns internally. For instance, some BOCs permit ESPs to order network services for their ESPs' customers, thereby minimizing the BOC's contact with those customers.[141] In addition, BellSouth and Pacific state that they have instructed their service representatives not to market enhanced services to customers when they call to order network services for use with another ESP's service.[142]

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[136] AAR Comments at 2; ICA Comments at 15; TCA Comments at 4; UTC Comments at 4-6; ONA Users Group Reply at 2-4.

[137] Ameritech Reply at 21-21; Bell Atlantic Comments at 15-18; BellSouth Comments at 33-34; NYNEX Comments at 60-62; Pacific Comments at 58-59; SWBT Comments at 49-50.

[138] SWBT Reply at 49-51.

[139] *See* Bell Atlantic Comments at 16-17; *see also* Pacific Comments at 58-63, SWBT Comments at 49.

[140] *See* Bell Atlantic Reply at 13; BellSouth Reply at 33; Pacific Comments at 60. *But see* Sprint Reply at 6 (low number of requests for CPNI may reflect difficulty of obtaining customer authorizations, not the low value of the information).

[141] BellSouth Comments at 33-34.

[142] BellSouth Comments at 33-34; Pacific Comments at 52.

81. Finally, the BOCs argue that their access to CPNI is no different from an unregulated company's access to its customer records and should therefore be permitted. Ameritech asserts that the antitrust laws prove that the BOCs' use of CPNI does not give them an unfair competitive advantage, citing *Catlin v. Washington Energy Co.*[143] as holding that a natural gas utility was free to use its customer list to market gas-related products in competition with others.[144]

82. On the issue of privacy, differing views were expressed on whether the BOCs' use of CPNI is in accord with customers' expectations. The BOCs assert that people generally expect the companies with which they have an ongoing business relationship to have information about their past transactions, and to use that information occasionally to market new services to them.[145] Some of the BOCs argue as well that customers will actually be upset if all BOC personnel do not have access to their records.[146] Other [7609] parties, however, challenge the BOCs' assertion that the current rules are in accord with customers' privacy expectations.[147]

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[143] 791 F.2d 1343 (9th Cir. 1986).

[144] Ameritech Reply at 20.

[145] Ameritech Comments at 26; BellSouth Reply at 41; NYNEX Comments at 57-60, Appendices A & B; Pacific Comments at 54-55; SWBT Comments at 51; US West Comments at 70-71.

[146] BellSouth Reply at 49 (Florida customers subject to prior authorization have complained about BOC personnel inability to access account information); *see also* NYNEX Comments at Appendix A, pp. 28-29; Pacific Comments at 54-55.

[147] *See e.g.*, ATSI Reply at 12; ONA Users Group Comments at 4-6, Reply at 2-4; ANPA Comments at 43; Pennsylvania Comments at 13; Alarm Industry Comments at 10-11.

83. With regard to efficiency, the BOCs and USTA argue that any prior authorization requirement will effectively impose structural separation on their enhanced services marketing activities, asserting that a prior authorization rule would require the use of separate sales forces for basic and enhanced services.[148] BellSouth states that as a result of a Florida rule requiring prior authorization for BOC-initiated contacts, the cost of reaching the mass market is higher, and fewer customers are being contacted and offered services from which they might benefit.[149] Other commenters argue that the BOCs have exaggerated the difficulty of structuring their workforces to comply with a prior authorization rule[150] and of obtaining customer consent to access CPNI, particularly in view of the BOCs' assertions that customers do not object to BOC use of their CPNI.[151] Sprint suggests that to the extent prior authorization does result in some loss of efficiency, prior authorization should not necessarily be rejected, as efficiency is only one of the policy objectives cited by the Commission.[152]

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[148] Ameritech Comments at 25-26; Bell Atlantic Comments at 15; BellSouth Comments at 30-32; NYNEX Comments at 51-52; Pacific Comments at 49-54; USTA Reply at 18-21.

[149] BellSouth Reply at 47-50.

[150] *See* ONA Users Group Reply at 4; DC Public Service Commission Reply at 10-11; TCA Reply at 10.

[151] McGraw-Hill Reply at 14-15; DC Public Service Commission Reply at 10-11; TCA Reply at 10.

[152] Sprint Reply at 4-5.

3. *Discussion*

84. The CPNI rules for enhanced services were intended to balance considerations of efficiency, competitive equity, and privacy. Having had the opportunity to monitor the operation of the CPNI rules since their adoption, we now conclude that a change in those rules is appropriate to better balance these three important interests. Accordingly, we will require that, for customers with more than twenty lines, BOC personnel involved in marketing enhanced services obtain written authorization from the customer before gaining access to its CPNI.

85. The current rule enables the BOCs to engage in integrated marketing and sales of basic and enhanced services, thereby providing a number of benefits, especially in developing a mass market for enhanced [7610] services. Permitting the BOCs greater freedom in marketing enhanced services to residential and smaller business customers can help to increase the customers' knowledge about such services. BOC marketing efforts that make consumers more aware of the benefits of enhanced services should expand the market for such services, benefitting both consumers and ESPs.[153] The integrated marketing to consumers and smaller businesses made possible by the current CPNI rule not only allows the BOCs to provide basic and enhanced services more efficiently, but also provides direct benefits to customers in the form of "one stop

[153] *See Phase II Reconsideration Order*, 3 FCC Rcd at 1162, para. 97.

shopping." For instance, without the integrated marketing and sales made possible by our CPNI rules, if a customer called the telephone company to discuss basic network services, such as additional lines or call waiting, and then wanted merely to get information about an enhanced service, such as voice mail, he would have to be transferred to a separate enhanced services representative who would likely ask him to repeat much of the information that he had already provided.[154] With integrated marketing and sales, the BOC service representative receiving a call can also offer consumers additional choices that may better suit their needs, including combinations of basic and enhanced services. For instance, a customer service representative might suggest a voice mail service to record messages when the customer's line is busy as a more economical alternative to ordering additional lines. If a prior authorization rule were applied to all customers, only the largest business customers would be able to enjoy one-stop-shopping benefits of the integrated marketing of basic and enhanced services.[155]

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[154] That this is the likely result of a prior authorization requirement is confirmed by the ONA Users Group, who, in arguing that the BOCs could easily comply with a prior authorization requirement, asserts that the BOCs could have regulated service personnel respond to all general inquiries, and refer to enhanced services personnel any inquiries about enhanced services. ONA Users Group Reply at 4. *See also* TCA Comments at 10.

[155] Applying a prior authorization rule for other than the largest customers likely would require a BOC to establish separate enhanced and basic service marketing forces for those customers.

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[7611] 86. The current rules do raise some competitive issues, however. In this proceeding, most commenters argue for greater restrictions on BOC access to CPNI, and the record indicates that their unrestricted access to CPNI does give the BOCs an advantage over competing ESPs in marketing enhanced services to BOC customers. This advantage is of particular importance with respect to large business customers, as their CPNI is most likely to be of competitive value, due to the volume and nature of business involved. [156] The CPNI of large business customers raises competitive issues not only for ESPs competing with the BOCs, but also for the customers

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Unlike the largest business customers, which are likely to have relatively frequent contacts with their local BOCs through telephone company representatives specifically assigned to them, mass market customers commonly have only sporadic contacts with BOC telephone personnel, calling blind into the BOC's business office whenever they have questions or desire services from the telephone company. Thus, the BOCs can be expected to staff their business offices with personnel able to respond to most customer's basic services inquiries. If a customer has restricted CPNI, whether through action or inaction, then for basic services that customer must deal with "network-services-only" personnel, i.e., those with no involvement with enhanced services marketing or sales, because only those personnel are permitted under the Commission's CPNI rules to have access to restricted CPNI. Under a prior authorization rule, a large majority of mass market customers are likely to have their CPNI restricted through inaction, and in order to serve them the BOCs would have to staff their business offices with network-services-only representatives, and establish separate marketing and sales forces for enhanced services. Thus, a prior authorization rule would vitiate a BOC's ability to achieve efficiencies through integrated marketing to smaller customers—one of the benefits sought through adoption of nonstructural safeguards rather than structural separation.

[156] *See Phase II Order*, 2 FCC Rcd at 3096, para. 164.

themselves. Some large business customers have expressed concern about the competitive implications for them of unrestricted BOC access to their CPNI,[157] suggesting that CPNI records can reveal sensitive marketing strategies, expansion plans, innovative uses of telecommunications, customer lists, costs, and other confidential business information and therefore should not be revealed to anyone, including the BOCs' enhanced services operations, without the customer's consent.[158] At the same time, the BOCs are most likely to be able to obtain prior authorization from those customers because the BOCs in many cases already have established special sales relationships with them. Accordingly, a prior authorization rule for large business customers will achieve complete competitive equity for a valuable market segment while leaving intact the public interest benefits of joint marketing for smaller customers and not severely disrupting those for large business customers either. We will therefore change the CPNI rules to require prior authorization for customers with more than twenty lines.[159]

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[157] ICA Comments at 14-15; TCA Comments at 3-5. The Utilities Telecommunications Council indicated that utilities are very concerned about the security of their communications services, and limit the information that they reveal even to the telephone companies on a strict "need to know" basis. UTC Comments at 5.

[158] For instance, AAR indicates that some customers may want to restrict CPNI access to lessen the danger that their network design and usage patterns might be disclosed to competitors. AAR Comments at 2. TCA argues that as the BOCs enter unregulated businesses, they will find themselves increasingly in competition with their customers. TCA Comments at 4.

[159] We note that although customer privacy has always been one of the Commission's concerns in addressing CPNI, our focus in this order is on competitive equity and efficiency. To the extent

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[7612] 87. In order to provide additional safeguards in those areas where competitive concerns are greatest while at the same time minimizing the extent to which the benefits to be derived from the current rules are diminished, we must identify that group of large business customers whose CPNI should be subject to prior authorization. The record does not reflect a consensus as to what would be the best method, and there may be varying administrative burdens on the BOCs to implement any approach to defining large business customers because the BOCs have established different internal definitions of large business customers and marketing organizations to serve them. Parties have suggested different methods by which such customers could be identified, such as a number of lines test,[160] or an external source such as the Fortune magazine rankings of companies by size.[161] External sources do not take account of a customer's use of telecommunications services in the way that a number of lines approach does, and it is the use of communications services that is significant for our

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that CPNI is available to BOC personnel involved in marketing enhanced services, information is available only within a single integrated company, and we do not believe that such internal BOC access to CPNI generally raises significant privacy concerns. Although privacy concerns are implicated by disclosure of CPNI to third parties outside the BOC, the CPNI rules have always protected against such disclosure. A more extensive prior authorization rule is not necessary to protect customers' privacy interests.

[160] *Ex Parte* Letter from Gary L. Dennis, Director, Federal Regulatory, BellSouth, to Donna R. Searcy, Secretary, FCC, November 1, 1991.

[161] *Ex Parte* Letter from Shelley E. Harms, Attorney, NYNEX, to Donna R. Searcy, Secretary, FCC, October 10, 1991.

purposes. We therefore conclude that a number of lines test is more effective. While the BOCs all oppose any prior authorization rule, three have suggested in the alternative that we impose a prior authorization requirement for customers of 50 or more lines, while one has suggested a prior authorization requirement for customers of more than 20 lines.[162] We conclude that BOC personnel involved in enhanced services marketing should obtain prior authorization before accessing the CPNI of customers with more than twenty lines. This rule preserves the benefits of our current rules for the further development of enhanced services for the mass market, while providing additional safeguards with respect to those customers whose CPNI might provide the greatest competitive advantage to the BOCs and raises competitive issues for the customers themselves.[163]

[7613] 88. Some of the BOCs question whether the Commission may change the CPNI rules, asserting that there are no changed circumstances to

[162] *See e.g., Ex Parte* Letters from Elridge A. Stafford, Director, Federal Relations, US West, to Patrick Donovan, Attorney, FCC, November 4, 1991; Gary J. Dennis, Director, Federal Regulatory, BellSouth, to Donna R. Searcy, Secretary, FCC, November 1, 1991; and Shelley E. Harms, Attorney, NYNEX, to Donna R. Searcy, Secretary, FCC, October 10, 1991.

[163] To the extent that customers may have more than twenty lines distributed among multiple locations, each of which has fewer than twenty, the BOCs should treat these customers as subject to the prior authorization rule if it is practically feasible to identify them as having more than twenty lines in total. Where the BOC treats several locations as belonging to the same customer for other purposes, it should do so for CPNI as well, unless good cause is shown for doing otherwise. In any event, we require that, in implementing the CPNI rule, the BOCs must treat a customer as having more than twenty lines whenever the customer has more than twenty lines at one location.

justify such a decision.[164] The Commission, however, does have the authority and, indeed, the obligation to reexamine its regulatory policies to ensure that they continue to serve the public interest. "An agency is not prohibited from changing its mind. '[F]aced with new developments or in light of reconsideration of the relevant facts and its mandate, [the agency] may alter its past interpretation and overturn past administrative rulings and practice.' "[165] Having concluded that the public interest would be better served by the rules adopted in this Order, we are not only authorized but obligated to change our rules.

89. Accordingly, we are amending our CPNI requirements to provide that BOC personnel engaged in the marketing of enhanced services may not access the CPNI of customers with more than twenty lines unless they have obtained the permission of the customer. We require the BOCs to implement this requirement six months from the date of release of this *Report and Order.*[166] We will require that the BOCs implement our revised prior authorization rule in a nondiscriminatory manner. The CPNI rules for enhanced services as they apply to other customers

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[164] *See* Bell Atlantic Comments at 15; SWBT Comments at 57; US West Comments at 30.

[165] *Spartan Radiocasting Co. v. FCC*, 619 F.2d 314, 322 (1980), citing *American Trucking Ass'n v. Atchison, Topeka and Santa Fe Railway Co.*, 387 U.S. 397, 416 (1967).

[166] In our companion order, we require each BOC to file an amendment to its ONA plans describing, *inter alia*, changes to its CPNI procedures necessary to implement our revised CPNI rule. *See* Filing and Review of Open Network Architecture Plans, CC Docket No. 88-2, Phase I, FCC 91-382, at para. 54 (released December 19, 1991).

remain unchanged.[167] By continuing to permit the BOCs' enhanced services operations to have access to the CPNI of most customers, we are not authorizing the practice of "unhooking," the targeting of enhanced service sales pitches at customers who [7614] contact the BOC to order network services to use with a competitor's enhanced srvice.[168] We find that practice to constitute an abuse of the BOCs' positions as providers of basic services, and will investigate claims that any BOC is engaging in such a practice.

D. *Public Interest Analysis*

1. *Background*

90. Using a cost/benefit analysis, the Commission concluded in *Computer III* that, when compared to nonstructural safeguards, a structural separation requirement for BOC provision of enhanced services imposed significant costs on both the BOCs and the public. Those costs included decreased efficiency, innovation, and service availability caused in part by the requirement for BOC duplication of facilities and personnel as well as by limitations on joint marketing. The Commission

[167] For instance, the notification requirement remains in place for those multiline business customers whose CPNI is not subject to prior authorization. In addition, the rules regarding the use of aggregated CPNI and disclosure of CPNI to independent ESPs remain unchanged. Similarly, the rules applicable to the use of CPNI in marketing CPE are not affected by this Order.

[168] In the Matter of the Commission's Investigation into Southern Bell Telephone and Telegraph Company's Provision of Memory Call Service, Order of the Commission, Georgia Docket No. 4000-U (June 4, 1991).

found that, relative to nonstructural safeguards, the costs of structural separation outweighed the benefits.[169]

91. The *California* Court, however, vacated the *Computer III* decision because it concluded that the Commission had not presented sufficient justification for reliance on cost accounting safeguards to guard against cross-subsidization so soon after the Commission's decision in *BOC Separation Order* to continue structural separation for BOC enhanced services. Despite the remand, the Court upheld the fundamental *Computer III* determination that BOC structural separation requirements impose significant public interest costs. The Court observed that the record in that proceeding supported the conclusion that lifting the structural separation requirements would benefit consumers of enhanced services by permitting the BOCs to operate more efficiently in the enhanced services market. The Court said the record supported the Commission's finding that "the BOCs have had to raise the price of certain services, withhold others from the market, and perhaps never develop still others because of the inefficiencies of structural separation."[170] Moreover, the Court stated that the Commission showed that "the integration of regulated and unregulated telecommunications services by the BOCs would yield some economies of scale."[171]

2. *Comments*

92. Most commenters in this proceeding either support, or do not oppose, institution of nonstructural

[169] *Phase I Order*, 104 FCC 2d at 1011-1092.

[170] *California*, 905 F.2d at 1231.

[171] *Id.*

safeguards for BOC provision of enhanced [7615] services. NTIA, DOJ, and IBM, for example, strongly support reinstatement of nonstructural safeguards rather than a structural separation requirement.[172] GSA also opposes any rule that would preclude or inhibit the physical integration of enhanced services into the facilities and equipment that provide basic services.[173]

93. The BOCs generally contend that the American public will benefit as a result of the efficiencies of integrated offerings of basic and enhanced services.[174] They argue that experience with structural separation demonstrates that it hinders the introduction and development of enhanced services, which would otherwise benefit the public by being widely available through the BOCs' local exchanges. They contend that a structural separation requirement imposes direct costs because it mandates the duplication of facilities and personnel and limits joint marketing. The BOCs assert that the biggest cost of structural separation is that, without integration, most enhanced services would not be offered to the mass market in the foreseeable future.[175]

94. The BOCs claim that the removal of BOC structural separation already is producing the benefits anticipated by the Commission, as shown by

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[172] NTIA Comments at 6-7; DOJ Comments at 4-7; IBM Comments at 2-5.

[173] GSA Reply at 20; *see also* Illinois CC Comments at 7.

[174] Bell Atlantic Comments at 7; BellSouth Comments at 5-14; NYNEX Comments at 9-11; Pacific Comments at 5-7; SWBT Comments at 6; US West Comments at 18-25; Bell Atlantic Reply at 5; BellSouth Reply at 10-14; Pacific Reply at 3-13.

[175] *See e.g.*, Pacific Reply at 9, SWBT Reply at 30; NYNEX Reply at 5.

BOC experience with voice mail in the mass market.[176] According to NYNEX, the LECs are the one industry segment with the resources, experience, and established relationships to educate the average consumer about the availability and advantages of enhanced services, and to develop and offer integrated packages tailored for small business and residential customers' needs.[177] They further assert that integration benefits business competitiveness and productivity generally, as well as increases availability of other enhanced services.[178]

95. Commenters urging adoption of a structural separation requirement claim that the risk of successful anticompetitive conduct by the BOCs under nonstructural safeguards outweighs any possible benefits of [7616] integrated provision of interstate basic and enhanced services.[179] Some commenters argue that the *Notice's* cost/benefit analysis places too much weight on the perceived efficiencies resulting from removal of structural separation, and too little on the protection it offers to consumers and competition.[180] They also argue that a structural separation requirement would be much easier to enforce.[181]

96. Commenters favoring a structural separation requirement claim that its elimination is not required to bring enhanced services to the public,

[176] *See e.g.*, Pacific Comments at 5-13; Bell Atlantic Comments at 3-9; NYNEX Comments at 11-12; Bell Atlantic Reply at 5.

[177] NYNEX Comments at 11.

[178] US West Comments at 18-25; Ameritech Comments at 7-8.

[179] *See e.g.*, Ad Hoc Comments at 19-27; MCI Comments at 29-30; ANPA Reply at 2; CompuServe Reply at 3-6.

[180] CompuServe Comments at 12.

[181] *See e.g.*, ADAPSO Comments at 9-12; MCI Comments at 94-95; IDCMA Reply at 3.

and will not result in the BOCs providing more, or innovative, enhanced services.[182] These parties claim that there is no record support that there are any efficiencies available from integration, that the price of enhanced services will rise without integration, or that structural separation imposes significant costs.[183] Several parties contend that Ameritech's provision of enhanced services through separate subsidiaries and that the provision by other BOCs, such as Pacific Bell, of certain enhanced services through separate subsidiaries proves that structural separation imposes no costs and that nonstructural safeguards have no real benefits for BOC provision of enhanced services.[184] ADAPSO suggests that structural separation could be flexibly implemented to allow integration whenever BOCs can demonstrate real benefits through a waiver process.[185]

97. In reply, the BOCs dispute contentions that enhanced services are widely available to the mass market. They assert instead that the availability and quality of enhanced services for residential and small business consumers are still far behind several industrial nations in Europe and Asia.[186] They also disagree that a return to the *Computer II* waiver process would be a viable alternative to nonstructural safeguards since this [7617] would introduce unwarranted delay and other costs into the delivery of new services.[187]

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[182] CompuServe Comments at 13; MCI Comments at 10, 12-13.

[183] Ad Hoc Comments at 19-27; ANPA Comments at 24; CompuServe Comments at 10; DC PSC Comments at 3-9, MCI Comments at 10-14; Pennsylvania PUC Comments at 4; ANPA Reply at 7; CompuServe Reply at 8; IDCMA Reply at 2.

[184] MCI Comments at 8-16, 35-38.

[185] ADAPSO Comments at 31.

[186] *See e.g.*, Pacific Reply at 4.

[187] NYNEX Reply at 9; US West Reply at 34-35.

3. *Discussion*

98. As set forth above in detail, we have developed a set of strengthened nonstructural safeguards that will protect against cross-subsidization and discrimination. We conclude that permitting the BOCs to participate in the enhanced services industry pursuant to this set of safeguards will not result in significant public interest costs. The benefits, in contrast, are substantial and lead us to conclude that on balance, the public interest is better served by eliminating the structural separation requirement. We find that this approach will permit the BOCs to use their resources more efficiently to provide enhanced services, resulting in the wider availability of enhanced services to the public, while effectively ensuring that BOC participation in enhanced services does not adversely affect basic service rates or harm ESPs due to BOC anticompetitive conduct.

99. Contrary to the assertions of some commenters, we conclude that the BOCs hold great potential for providing a wide variety of enhanced services throughout the country, especially on a mass market basis. The BOCs own, manage, and control an important portion of our nation's telecommunications assets and resources, including not only communications facilities, but also the associated management and operational resources essential for providing all kinds of communications services feasible with existing an emerging technologies. These resources provide the BOCs with a substantial foundation for providing such communications-based services as enhanced services. For example, the geographic dispersion of facilities throughout the

BOC regions makes it possible for the BOCs to serve many communities not economic for others. The BOCs' existing marketing contacts with customers provide a ready, inexpensive opportunity for the marketing of enhanced services.[188] In addition, because the BOCs already serve large numbers of households in their respective regions, they have a substantial ability to use their existing assets and resources to provide enhanced services to the consumer market.

100. We conclude as well that the BOCs cannot fully realize their potential in the enhanced services marketplace unless they are permitted to capture the legitimate efficiencies available to them. Provision of enhanced services on an integrated basis with basic services can result in operational efficiencies, economies of scope, and cost savings by avoidance of separation and/or duplication of assets and personnel required by a regulatory requirement for structural separation. For example, the BOCs can be more efficient by: (1) using existing sales contacts to market enhanced services [7618] rather than establishing new, separate sales forces;[189] (2) using the same personnel to repair and install equipment used to provide basic and enhanced services rather than using different personnel;[190] and (3) using existing expertise in research and development that may have application to enhanced and basic services rather than

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[188] BellSouth states that it has millions of marketing contacts annually with customers. BellSouth Comments at 42.

[189] *See e.g.*, NYNEX Comments at 11-14, 18; Pacific Comments at 4, 24; SWBT Comments at 16; US West Comments at 16.

[190] *See e.g.*, NYNEX Comments at 17-20; SWBT Comments at 13-14.

seeking to do so separately for enhanced services.[191] The existence of such potential efficiencies is confirmed both by the history of the enhanced services market and by the record in this proceeding.

101. Since *Computer II* and the *BOC Separation Order*, the Commission has gained substantial experience with application of both structural separation and nonstructural safeguards as regulatory frameworks governing BOC provision of enhanced services. That experience demonstrates that, relative to nonstructural safeguards, mandatory structural separation has significantly dampened BOC provision of enhanced services.[192] During the *Computer II* regime and prior to our CEI requirements, most BOCs provided few enhanced services, and only then subject to waivers of *Computer II* granted after lengthy proceedings.[193] *Computer III* pointed to the *Custom Calling Denial Order* as evidence of the impact of structural separation on the likelihood of the BOCs providing enhanced services to the public.[194] In that decision, the Commission denied the request of AT&T (which

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[191] *See e.g.*, NYNEX Comments at 14-17; US West Comments at 16; SWBT Comments at 10-12, 16.

[192] In the first triennial review of the *MFJ*, the District Court modified the information services restriction to permit the BOCs, *inter alia*, to provide voice storage and retrieval services. United States v. Western Electric Co., 673 F.Supp. 525 (D.D.C. 1987); United States v. Western Electric Co., 714 F.Supp. 1 (D.D.C. 1988); 767 F.Supp. 308 (D.D.C. 1991).

[193] Petitions for Waiver of Section 64.702 of the Commission's Rules (Computer II), *Memorandum Opinion and Order*, 100 FCC 2d 1057 (1985).

[194] American Telephone and Telegraph Co. Petition for Waiver of Section 64.702 of the Commission's Rules and Regulations, 88 FCC 2d 1 (1981).

then included the BOCs) for waiver of the *Computer II* requirement for structural separation to provide network-based voice mail services based on the view that, even if AT&T were not permitted to integrate the voice storage and retrieval feature into its basic service offerings, competitors would offer comparable services. However, no fully comparable services were offered.[195] [7619] Thus, structural separation appears, as a practical matter, to have completely foreclosed the offering of this service to the public. The BOCs also provide specific examples of new services that have been affected by the imposition of a structural separation requirement after the *California* decision.[196]

102. By contrast, our experience with nonstructural safeguards shows that removal of structural separation requirements has resulted and will result in greater BOC participation in the provision of enhanced services. Under CEI plans, the BOCs have participated to a much greater degree in providing enhanced services than under structural separation. For instance, under CEI plans or market

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[195] Telephone answering machines and telephone answering service bureaus provide very valuable types of voice storage and retrieval services. In *Computer III* we stated that the distinguishing characteristic of network based voice mail services is their ubiquity and their easy availability to casual users. *Phase I Order*, 104 FCC 2d at 1112, para. 313.

[196] US West, for example, states that it has foregone development of its proposed fax store and forward service since the reimposition of the *Computer II* regime following the Ninth Circuit decision. US West Comments at 26. NYNEX states that the future of certain enhanced services that were in the planning and development stage when the Court vacated *Computer III* is now uncertain since it is unclear when, if ever, they may be pursued on an integrated basis. NYNEX Comments at 20, n. 32.

trials, the BOCs have provided, or sought to provide, voice mail service, E-mail, gateways, electronic data interchange, data processing, voice store-and-forward, and fax store-and-forward services. Some of these services have been of an experimental nature, such as gateways, confirming our view in *Computer III* that the BOCs can bring innovative enhanced services to the public.

103. BOC experience with voice mail has been particularly telling. Since the BOCs have been permitted to provide voice storage and retrieval services under nonstructural safeguards, they have vigorously competed in the provision of voice mail service at a reasonable price to consumers. As of the time of filing comments in this proceeding, Bell Atlantic provided its voice mail service to nearly 120,000 subscribers after one year of general availability.[197] It expected this number to grow to 350,000 subscribers in 1991. NYNEX's voice mail service was available to over 850,000 access lines.[198] US West provided voice mail service to approximately 200,000 subscribers.[199] Pacific, which makes use of an integrated sales force in the marketing of its voice mail service, provided service to 2000 new residential customers each week during the first three months that it offered the service.[200] Contrary to assertions of some commenters, this participation is [7620] substantial within the timeframe during which the

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[197] Bell Atlantic Comments at 4.
[198] NYNEX Comments at 13.
[199] US West Comments at 21-22.
[200] Pacific Comments at 8.

BOCs have been allowed to provide voice mail service pursuant to nonstructural safeguards.[201]

104. Generally confirming our conclusions of the significant efficiencies and economies of scope that could be gained from integrated provision of basic and enhanced services are BOC estimates of the costs of a structural separation requirement.[202] Operational

[201] BOC participation in the enhanced services marketplace has not injured competition. The BOCs report that voice mail services show solid trends of increasing output and decreasing price. The BOCs estimate that overall, the market for voice mail services grew between 1988 and 1989, with total revenues rising from $452 million to $635 million. *See* BOC Reply Memorandum filed in *United States of America v. Western Electric Company, Inc., and AT&T* (Civ. No. 82-0192), Appendix, Exhibit A citing "European, U.S. Voice Messaging Grow at Very Different Rates." *FinTech Telecom Markets* (September 20, 1990). Moreover, the BOCs further state that in the two years they have participated in the provision of voice mail services, the voice mail equipment market has grown threefold; prices have declined; the number of voice mailboxes has grown from 5.3 million to 11.6 million; and the market for voice mail services has increased by 40 percent from $452 million to $635 million. BOC Reply Memorandum, Table A-5. Similarly, in the two years that the BOCs have provided videotext gateways, total subscribers to all videotext gateways have increased from 715,000 to 1.8 million and are continuing to multiply at a rate of 15-20 percent each year. BOC Reply Memorandum, Table A-11.

[202] *See, e.g.*, US West Comments at 17-28; Ameritech Comments at 3-4; Bell Atlantic Comments at 3; BellSouth Comments at 5-13; NYNEX Comments at 9-10; SWBT Comments at 6-12. *See also* Unisys Comments at 3; NTIA Comments at 6-7. We reject the view of some commenters that we may not, or should not, consider the BOCs' estimates of cost savings and efficiencies of integration because the underlying data have not been submitted and cannot be verified, and because the estimates of efficiencies vary among the BOCs. *Ex Parte* Letter from Frank W. Krogh, Appellate Counsel, Regulatory Law, MCI, to Donna R. Searcy,

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efficiencies in some of [7621] these areas may be essential to serving the consumer market. Pacific Bell and US West have estimated that the one time costs for transferring and/or duplicating facilities and personnel could be as high as $10-$15 million for structurally separate provision of voice mail services.[203] Various BOCs estimate that the costs of providing some enhanced services under structural

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Secretary, FCC, November 12, 1991; *Ex Parte* Letter from Warner Sinback, Chairman, Domestic Communications Committee, Information Technology Association of America, to Donna R. Searcy, Secretary, FCC, November 13, 1991. While the BOCs have not submitted complete substantiation of their estimates of cost savings and efficiencies, the information submitted is sufficient to confirm and support our finding that allowing the BOCs to participate in the enhanced services market pursuant to nonstructural safeguards will achieve efficiencies and economies of scope. For instance, some of the BOCs have provided information as to how they arrived at these estimates and, in some cases, have provided a categorization and quantification of the types of costs and revenues that were used in estimating the cost savings of integration. *See e.g., Ex Parte* Letter from Trudi W. Blair, FCC Relations, Bell Atlantic, to Donna R. Searcy, Secretary, FCC, November 7, 1991. Commenters have not shown that the manner in which these BOCs arrived at their estimates has precluded their use as evidence confirming the other record information that nonstructural safeguards would permit the BOCs to operate more efficiently in the enhanced service marketplace than would structural separation. We also find that the range of specific BOC estimates does not undermine their confirmation of our broad public interest finding of the efficiency benefits of nonstructural safeguards.

[203] *Ex Parte* Letter from Celia Nogales, Federal Regulatory Relations, Pacific, to Donna R. Searcy, Secretary, FCC, September 20, 1991; *Ex Parte* Letter from Elridge A. Stafford, Director, Federal Relations, US West, to Donna R. Searcy, Secretary, FCC, September 26, 1991.

separation could be up to 68%[204] higher than under integration and necessitate price increases of as much as 30%[205] and 80%[206] US West estimates that increased marketing expenses alone under structural separation would increase the price of its voice mail service by 30%.[207] The BOCs state that marketing studies reveal that at this level of price increase there would be a significant decline in demand for some enhanced services rendering them uneconomical to provide.[208]

105. We therefore find that the BOCs hold great potential for providing enhanced services, and that the use of nonstructural safeguards in lieu of structural safeguards permits a fuller realization of that potential. We conclude that a major benefit of adopting nonstructural safeguards is that this course would permit the BOCs to take advantage of operational efficiencies of integration, facilitate BOC provision of enhanced services, engage in joint marketing of basic and enhanced services, and will result in a greater provision of enhanced services, especially in the mass market.[209] [7622] By mandating

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[204] *Ex Parte* Letter from William A. Blase, Director, Federal Relations, Southwestern Bell, to Donna R. Searcy, Secretary, FCC, October 11, 1991.

[205] *Ex Parte* Letter from Elridge A. Stafford, Director, Federal Relations, US West, to Donna R. Searcy, Secretary, FCC, September 26, 1991.

[206] Bell Atlantic Comments at 5.

[207] *Ex Parte* Letter from Elridge A. Stafford, Director, Federal Relations, US West, to Donna R. Searcy, Secretary, September 26, 1991.

[208] NYNEX Comments at 10; Bell Atlantic Comments at 5.

[209] Our nonstructural safeguards benefit basic service ratepayers as well, relative to mandatory structural separation. As indicated, para. 48, *supra*, under our cost accounting rules, the

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the physical separation of assets and personnel used to provide enhanced services from those used to provide basic services, a structural separation requirement would eliminate all opportunity to realize the efficiencies and cost savings of integration. We do not agree with commenters who argue that other considerations would outweigh the benefits of integration. These commenters urge that any possible benefit of integration is outweighed by the relative ineffectiveness of nonstructural safeguards in protecting against cross-subsidization and discrimination. As detailed above, we find that the comprehensive set of nonstructural safeguards identified in this proceeding constitutes an effective regulatory alternative to structural separation for protecting against such abuses. Moreover, to the extent that nonstructural safeguards may involve any small diminution in protection against cost-subsidization and discrimination, we find that the danger of this is outweighed by the benefits of integration.

106. Similarly, we disagree with commenters who contend that heavier administrative burdens imposed by nonstructural safeguards require that we adopt a *Computer II* regime of structural separation. We have had several years' experience implementing cost accounting rules and other safeguards under *Computer III's* CEI regime for BOC provision of

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BOCs must use a fully distributed costing methodology to allocate costs between enhanced and basic services. This means that some of the savings resulting from integrated provision of basic and enhanced services must contribute towards general overhead costs of the basic service operations. This would not be the case under structural separation.

enhanced services. The resulting administrative burden does not lead us to conclude that use of nonstructural safeguards in the future will be an unacceptable administrative burden. Moreover, the future administrative burden of nonstructural safeguards may somewhat be reduced because it will not be necessary under ONA to approve use of nonstructural safeguards on an individual service basis, as under CEI. Further, structural separation imposes administrative burdens. Enforcement of structural separation, including review of affiliate transactions, requires significant administrative resources, as does evaluation of reasonably expected waiver requests. Thus, we do not find significant administrative advantages to structural separation.

107. We also conclude that we should not permit use of nonstructural safeguards only for particular enhanced services and/or permit only partial integration of some or all enhanced services. For example, some parties suggest that we should require the BOCs to offer enhanced services through a separate subsidiary generally, but permit joint activities whenever a BOC is able to demonstrate that it is more efficient or will result in benefits to the public. While it appears that some enhanced services may feasibly be provided using some form of a separate corporate subsidiary,[210] [7623] that does not persuade us to attempt to implement some modified

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[210] Ameritech has chosen to provide enhanced services primarily through purchase of separate entities already providing enhanced services. Ameritech has elected not to integrate into the corporate parent. Ameritech Comments at 5-7. A decision not to integrate purchased, already freestanding, operational entities into existing carrier operations does not show that there are no efficiencies from integration.

structural separation requirement. Such an approach would involve case-by-case evaluation of enhanced service offerings, which would be cumbersome and time consuming and delay introduction of service offerings. Moreover, it would require us simultaneously to apply some form of separate subsidiary requirement for some services or carrier activities and nonstructural safeguards for other services or activities. This would not eliminate the administrative burden of either approach. Finally, we see little benefit to this approach since we do not find, contrary to this approach's advocates, that there are substantial risks to nonstructural safeguards that make it desirable to remove structural separation only in narrow cases.[211]

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[211] Cox Cable and CompuServe contend that the procedings at the Georgia Public Service Commission (Georgia PSC) regarding provision by BellSouth of voice mail service in the state, pursuant to an approved federal CEI plan, show that nonstructural safeguards are ineffective in preventing anticompetitive conduct. In the Matter of the Commission's Investigation into Southern Bell Telephone and Telegraph Company's Provision of Memory Call Service, Order of the Commission, Georgia Docket No. 4000-U (June 4, 1991). The Georgia PSC proceedings do not show that our safeguards are ineffective. The findings at the state level regarding unfair marketing and discrimination are based on "unhooking," as well as the failure of BellSouth to make available to competing voice mail providers physical collocation and certain basic features and functions desired by them until BellSouth decided to provide its own voice mail service. As is made clear in this *Report and Order*, unhooking is unacceptable under our nonstructural safeguards. *See* paragraph 89, *supra*. Our CEI/ONA requirements ensure that ESPs obtain "equal access" interconnection, absent mandatory collocation. Moreover, our CEI/ONA requirements reasonably preclude discriminatory provision of basic services required by ESPs. Under our interim CEI requirements,

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108. In view of the foregoing, we conclude, contrary to our decision in *Computer II* and the *BOC Separation Order*, that based on a cost/benefit analysis, the record developed in this proceeding favors adoption of the nonstructural safeguards detailed above, rather than a structural separation requirement, to govern BOC participation in the [7624] enhanced services industry. We find that our strengthened nonstructural safeguards will permit the BOCs more fully to realize their potential in providing enhanced services to American consumers. We additionally find, in light of our determination that nonstructural safeguards will effectively protect against BOC cross-subsidization and discrimination, that a structural separation requirement is an unnecessary government intrusion into business judgments by the BOCs regarding the most effective

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BellSouth must make available to independent ESPs the underlying basic network functions that BellSouth uses in providing its own enhanced services. Our permanent ONA requirements are more far reaching, and require an unbundling and availability of basic network functions irrespective of whether they are used in providing BOC enhanced services. Thus, in an ONA environment, BellSouth would violate our requirements if it unreasonably refused to make available, prior to offering its voice mail service, basic services desired by its voice mail competitors. Such an unreasonable refusal to offer a basic service is not justified because the service is not included in the BOC's approved ONA plan. Concerning the possibility of cross-subsidization, we have implemented cost accounting safeguards, including cost allocation statndards, that define improper cross-subsidization. The Georgia PSC's finding of possible cross-subsidization at the state level is not sufficiently particularized at this time to permit evaluation of whether it may have any bearing on BellSouth's compliance with federal requirements.

corporate organization for the provision of enhanced services. A structural separation requirement for BOC provision of enhanced services would instead erect unnecessary barriers impeding the responsiveness of industry to marketplace incentives that foster increasing use and advancement of the nation's telecommunications assets. We therefore conclude to permit the BOCs to provide enhanced services pursuant to the nonstructural safeguards described in this *Report and Order* once all conditions for lifting structural separation have been met. In the interim, the BOCs are allowed to file CEI plans and CEI waivers under the requirements set forth in *Computer III*.[212]

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[212] In the *BOC ONA Amended Plans Order*, we stated that structural separation requirements will be removed for each BOC when it files a notice informing us that: (1) it is technically prepared to offer each of its initial ONA services; (2) federal tariffs for each of its initial interstate ONA services are in effect; and (3) it has filed state tariffs for each of its initial intrastate ONA services (although such state tariffs do not have to be effective for the removal of structural separation). *BOC ONA Amended Plans Order*, 5 FCC Rcd at 3105, para. 13. The BOCs have filed their federal ONA tariffs. All of the BOCs, however, have requested waivers of the *Part 69/ONA* requirement that they tariff all basic service elements listed in their approved ONA plans. *See* Pleading Cycle Established For Comments on Bell Operating Company Petitions for Waiver of ONA Tariffing Orders. *Public Notice*, CC Docket Nos. 89-79, 88-2, DA 91-1424 (released November 15, 1991). We conclude that, in order to meet the requirements stated above for removal of structural separation, federal tariffs for all initial services listed in the BOCs' approved ONA plans must be effective, unless the Common Carrier Bureau grants waivers. The Common Carrier Bureau will place all BOC petitions for structural relief on public notice, and may seek additional information from the BOC, if necessary. Once thirty days have passed from the release of the

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[7625] 109. We are confident that, for the reasons cited, the benefits of nonstructural safeguards substantially outweigh any marginal costs. As technology and its applications evolve, the enhanced services marketplace will continue to develop. ONA, too, is an evolving process. We deem it prudent, therefore, for the Commission to review the nonstructural safeguards after the seven BOCs have operated under a full ONA environment for three years.[213] Such a review will enable the Commission to evaluate whether nonstructural safeguards have been effective in promoting a competitive enhanced services marketplace while permitting the BOCs to provide enhanced services more efficiently on an

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public notice, and the Bureau is satisfied that the BOC has met the Commission's conditions for granting structural relief, the Bureau will issue an order or letter stating that structural separation requirements have been removed for the BOC. We also delegate to the Common Carrier Bureau the authority to oversee the process of removing structural separation requirements. In the interim period between the effective date of this Order and removal of structural separation, the BOCs may file CEI plans and CEI waivers. The BOCs are also permitted to provide enhanced services on an integrated basis pursuant to the *Computer II* waivers granted by the Commission following the *California* decision. The determinations in this *Report and Order* concerning removal of structural separation and adoption of nonstructural safeguards will become effective on February 1, 1992. On January 1, 1992, the BOCs may engage in integrated planning and development of enhanced services, once they have made any necessary amendments to their cost allocation manuals. *See e.g.*, Pacific and Nevada Bell Cost Allocation Plan of Enhanced Services Planning and Development, CC Docket No. 85-229, 2 FCC Rcd 1725 (1987).

[213] For purposes of this review, a fully effective ONA environment will exist when all seven BOCs are no longer subject to the *Computer II* structural separation requirement.

integrated basis, and whether any changes are necessary given our obligation to reevaluate regulations in light of changing conditions.

IV. *Preemption*

A. *Background*

110. In *Computer III*, the Commission preempted: (1) all state structural separation requirements applicable to the provision of enhanced services by AT&T, the BOCs, and the independents; (2) all state nonstructural safeguards applicable to AT&T and the BOCs inconsistent with federal safeguards; and (3) all state nonstructural safeguards applicable to the independents more stringent than those applied to AT&T and the BOCs.

111. In *California*, the Court vacated these preemption actions.[214] The Court was not persuaded that the Commission had adequately justified preemption of state structural separation requirements and of inconsistent nonstructural safeguards. The Court found that the Commission had failed to demonstrate that all state-imposed structural separation requirements would negate the federal interest in permitting AT&T and the BOCs to offer integrated enhanced services. The Court stated that the Commission had made a plausible argument that some forms of state structural separation

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[214] The *California* Court additionally found fault with the Commission's preemption in *Computer III* of state tariff regulation of intrastate enhanced services. In the *Notice*, note 96, we stated that we would not address in this proceeding preemption of state tariff regulation of intrastate enhanced services. Accordingly, we do not address that issue in this *Report and Order*.

requirements—for instance, those that could require physical separation of intrastate basic and enhanced service facilities—could negate federal policies permitting structural integration. The Court found, however, that the Commission had failed to explain how the possibility that some forms of state structural separation requirements could negate federal policy had [7626] justified the Commission's preemption of all state structural separation requirements. The Court also stated that *Computer III* had failed to address the possibility that some enhanced services might be offered on a purely intrastate basis. The Court found as well that the Commission had failed to justify the breadth of the preemption of inconsistent state nonstructural safeguards applicable to AT&T and the BOCs. Finally, the Court found inadequate the Commission's explanation for preemption of state imposition on the independents of nonstructural safeguards more stringent than those imposed by the Commission on AT&T and the BOCs.[215]

112. In the *Notice* the Commission sought to examine preemption of state requirements for structural separation of various specific facilities and personnel functions,[216] and only a limited number of specific state nonstructural safeguards, including

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[215] *California*, 905 F.2d at 1244.

[216] The Commission specifically sought comment on the impact on federal policies of state requirements that AT&T, the BOCs, and independents provide enhanced services using structurally separate: (1) communications facilities and equipment, (2) computer facilities and software, (3) other facilities, such as real estate and vehicles, (4) general management, (5) operations, (6) marketing, (7) installation and maintenance, and (8) research and development.

state network disclosure requirements that require initial disclosure at a time different from federal rules and different state CPNI and nondiscrimination reporting requirements. The Commission sought comment on whether any preemption in these areas should apply to state requirements applicable to AT&T and the independents as well as to the BOCs.

B. *Comments*

1. *In General*

113. Of those parties commenting on preemption issues, most contend as a general matter that the Commission can and should preempt state safeguards that will thwart or impede federal objectives.[217] US West Pacific Bell, and SNET, by contrast, contend that the Commission should wait to assess the need to preempt until a state adopts or proposes conflicting requirements.[218] US West argues that the Commission should not try to establish the nature of inseverability as a hypothetical matter, particularly [7627] when the nature of the service and the state regulation are unknown. [219] Pacific Bell urges that in this proceeding the Commission set forth guidelines for preemption of state safeguards. It contends that the Commission can and should preempt in the areas proposed in the Notice at the time a state establishes safeguards in those areas.[220]

[217] NYNEX Comments at 63; SWBT Comments at 59; Ameritech Comments at 31; AT&T Comments at 3; IBM Comments at 13; API Comments at 5-6; GSA Comments at 3; NTIA Comments at 18; NTCA Comments at 2-3; SNET Comments at 16; USTA Comments at 20-21.

[218] US West Comments at 110-111; Pacific Comments at 73; SNET Reply at 8-9.

[219] US West Comments at 108-111; US West Reply at 36-41.

[220] Pacific Bell Comments at 73-78.

114. A number of state public utility commissions oppose in general any preemption of possible state safeguard requirements without commenting on the specific areas of preemption addressed in the *Notice*. The Washington UTC claims that our preemption proposals are flawed because they ignore the intrastate nature of some enhanced services, citing voice mail service. The Washington UTC and NARUC argue that, because of the interexchange restriction of the MFJ, the BOCs do not provide any interstate enhanced services, and thus there is no federal interest at stake warranting preemption.[221] The New York DPS and NARUC assert that the Commission has not shown that the proposed preemption is necessary to prevent states from thwarting achievement of federal objectives.[222] The California PUC, Florida PSC, and NARUC contend that there should not be uniform nationwide safeguards, but safeguards that take account of different intrastate market conditions.[223] The California PUC, Illinois Commerce Commission, and NARUC suggest that the Joint Conference should resolve the preemption issues in this proceeding.[224]

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[221] WUTC Comments at 16; NARUC Comments at 5. *See also* MCI Comments at 96-101.

[222] New York DPS Comments at 9-11; NARUC Comments at 5-8.

[223] California PUC Comments at 7; Florida PSC Comments at 5; NARUC Comments at 14-15.

[224] California Comments at 9; California Reply at 4-6; NARUC Comments at 12-14. The Federal-State Joint Conference on Open Network Architecture was established by the Commission in the *BOC ONA Order* in response to industry and state comments in the *ONA Proceeding* urging the Commission to establish a forum for continuing dialogue and cooperation between the Commission and the states. The Joint Conference serves as a forum to facilitate federal/state cooperation and the successful development and implementation of ONA.

2. *Structural Separation*

115. Five of the BOCs, AT&T, and the independents support preemption of state structural separation requirements. Ameritech, Bell Atlantic, BellSouth, NYNEX and SWBT contend that it is not economically or practically possible for carriers to integrate provision of interstate enhanced services while simultaneously providing intrastate enhanced services [7628] pursuant to structural separation.[225] They claim that all of the facilities and personnel used to provide enhanced services are jointly used to provide interstate and intrastate enhanced services, and that there is no practical or economical way to permit simultaneously the integration of interstate enhanced services.[226] Ameritech argues that the BOCs would necessarily have to comply with the most restrictive requirements because the complexities and loss of economies of scale resulting from overlapping organizations designed to provide identical offerings in different jurisdictions would more than exceed the cost of complying with the most restrictive rule.[227] AT&T, in comments limited to the preemption issue, also supports a preemption of state structural separation requirements. It states that it has a single national unified network that provides both interstate and intrastate services that cannot as a practical matter be separated along jurisdictional lines.[228]

[225] Ameritech Comments at 30-31; Bell Atlantic Comments at 13; BellSouth Comments at 41-44; NYNEX Comments at 72; SWBT Comments at 63.

[226] Bell Atlantic Comments at 10-13; NYNEX Comments at 71; SWBT Comments at 63.

[227] Ameritech Comments at 30. *See also* Bell Atlantic Comments at 12; NYNEX Comments at 72; SWBT Comments at 62; Ameritech Comments at 30-31.

[228] AT&T Comments at 4-7; AT&T Reply at 6-9.

116. NTIA states that insofar as state and federal regulations require separation and integration of the same thing at the same time, the federal rule preempts the state one. It asserts that the FCC need not, and as a practical matter could not, analyze every possible safeguard a state may ever wish to impose.[229] Unisys, Integrated Communications Systems, Inc., and API support preemption of state structural separation requirements on the ground that it would make practically impossible the integrated offering of basic and interstate enhanced services. USTA, NTCA, GTE, SNET, Centel, and Cincinnati Bell support preemption of state structural separation requirements applied to independents for the same reasons advanced by the BOCs.[230]

117. Those states specifically commenting on this issue oppose preemption. The DC PSC, for example, states that the *Notice* failed to present any data demonstrating that any or all state structural separation requirements should be preempted. It states that the Commission has a very high burden under *California* to justify preemption. It claims that reorganization of personnel functions among corporate entities may not result [7629] in loss of efficiencies and, therefore, would not justify preemption.[231] The Florida PSC contends that, contrary to the *Notice's* assumption that there should be one nationwide solution for all services, states are

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[229] NTIA Comments at 19-20, 22.

[230] USTA Comments at 21; NTCA Comments at 3; GTE Comments at 3-4; SNET Comments at 16-17; Centel Comments at 12-14; Cincinnati Bell Comments at 8-9.

[231] DC PSC Reply at 16.

in a better position to assess the need for structural separation.[232] Other states raise similar concerns.[233]

3. *Customer Proprietary Network Information*

118. Ameritech, Bell Atlantic, BellSouth, NYNEX, Pacific Bell, SWBT, and AT&T urge the Commission to preempt state CPNI rules that would require prior authorization.[234] They basically argue that any state prior authorization rule would effectively bar access for both interstate and intrastate services because it would be impossible to have a prior authorization rule for intrastate enhanced services while at the same time allowing access under the federal rule.[235] NYNEX and SWBT urge that the Commission review other state CPNI requirements on a case-by-case basis.[236] Integrated Communications Systems, API, and USTA also argue that CPNI cannot be separated by jurisdiction, and that the we should preempt different state rules.[237] NTCA states that the Commission should preempt state regulation of independents to the same extent that we preempt state regulation of the BOCs.[238] The DC PSC states that since the FCC agrees that the customer, if he elects to do so, may restrict access to his CPNI, it is

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[232] Florida PSC Comments at 3.

[233] Vermont DPS Comments at 1; Pennsylvania Comments at 11; Hawaii Comments at 15-16.

[234] Ameritech Comments at 31; Bell Atlantic Comments at 18; BellSouth Comments at 46-47; Pacific Bell Comments at 79; NYNEX Comments at 78-79; SWBT Comments at 66.

[235] NYNEX Comments at 78; Pacific Bell Comments at 80.

[236] NYNEX Comments at 79; SWBT Comments at 66.

[237] ICS Comments at 13; API Comments at 9; USTA Comments at 23.

[238] NTCA Reply at 2.

not necessary for attainment of Commission goals to preempt states from determining that written customer authorization is to be required.[239]

4. *Network Disclosure Rules*

119. A number of parties urge the Commission to preempt various state network disclosure rules. AT&T urges the Commission to preempt any state network disclosure rule that requires earlier or broader dissemination [7630] of information than is required by the federal rule. Information is inseverable by jurisdiction, AT&T argues, and broader dissemination would frustrate the federal goal of safeguarding carriers' legitimate proprietary interests and promoting innovation by, and competition among, basic service providers.[240] Ameritech, Pacific Bell, NYNEX, Integrated Communications Systems, and Cincinnati Bell agree with the reasoning in the *Notice* that state requirements for initial disclosure at times different from times specified in the federal rule would negate the federal rule.[241] SWBT states that theoretically a state could impose an advance notice period that differed slightly but would not negate either the purpose or the effect of the FCC rule.[242] Centel and NTCA urge the Commission to preempt state network disclosure requirements applicable to the independents to the same extent as the BOCs.[243]

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[239] DC PSC Comments at 40; DC PSC Reply at 16-17.

[240] AT&T Comments at 11-13. *See also* USTA Comments at 22.

[241] Ameritech Comments at 31; Pacific Bell Comments at 80; NYNEX Comments at 80; ICS Comments at 13; Cincinnati Bell Comments at 9-10. *See also* Bell Atlantic Comments at 13.

[242] SWBT Comments at 67-68.

[243] Centel Comments at 16; NTCA Comments at 5-6.

120. The DC PSC contends that state network disclosure rules might not necessarily frustrate the ability of AT&T and the BOCs to provide integrated services. It asserts, however, that the Commission could preempt state requirements for initial disclosure after the make/buy point.[244]

C. *Discussion*

121. In this *Report and Order,* we have determined that the public interest will be best served if the BOCs are permitted to use their substantial resources to serve customers and provide interstate enhanced services pursuant to a comprehensive set of nonstructural safeguards instead of a *Computer II* regime of structural separation. AT&T and the independents are already permitted to provide interstate enhanced services pursuant to nonstructural safeguards.[245] As stated in the *Notice,* it is inevitable that [7631] state commissions will have different experiences and perspectives that may lead them to adopt safeguards that are at variance with each other, and with federal safeguards. These differences should be accommodated whenever

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[244] DC PSC Comments at 39-40; DC PSC Reply at 16-17.

[245] Nonstructural safeguards were reinstituted for AT&T's provision of enhanced services in Computer III Remand Proceeding, CC Docket No. 90-368, *Report and Order,* 5 FCC Rcd 7719 (1990). Independents have never been subject to structural separation for provision of enhanced services. All LECs other than average schedule companies are required to allocate costs between regulated and nonregulated activities in accordance with our cost allocation rules and policies. *Joint Cost Reconsideration Order,* 2 FCC Rcd at 6300, paras 154-159. Tier 1 LECs are subject to additional requirements, such as the requirement that they file cost allocation manuals. *Joint Cost Order,* 2 FCC Rcd at 1304, para. 47.

possible. Preemption of state regulation in this area should be as narrow as possible to accommodate differing state views while preserving federal goals. In this proceeding, we preempt state requirements for structural separation of facilities and personnel used to provide the intrastate portion of jurisdictionally mixed enhanced services, state CPNI rules requiring prior authorization that is not required by our rules, and state network disclosure rules that require initial disclosure at a time different than the federal rule. These state requirements would thwart or impede the nonstructural safeguards pursuant to which AT&T, the BOCs, and the independents may provide interstate enhanced services and the federal goals that they are intended to achieve.[248] We do not

[248] Contrary to the arguments of US West and Pacific that we should wait for states to impose requirements that would thwart federal objectives before considering whether to preempt them, we are preempting the specific state safeguards discussed below, for which a sufficient record now exists. This approach will ensure that federal objectives are not thwarted while avoiding the procedural and practical difficulties that would be occasioned by carriers; obligations to comply with state requirements such as structural separation, pending review by this Commission of petitions to preempt. Further, our decision to preempt certain state safeguards is not based on "hypothetical" factors. States are taking steps to impose safeguards that would thwart federal objectives. For example, the DC PSC has recently proposed to require that the C&P Telephone Co. provide enhanced services pursuant to structural separation. Formal Case No. 904, In The Matter of the Investigation of Enhanced Services, *Notice of Proposed Rulemaking* (September 13, 1991). The Georgia PSC has indicated that it may require separate organizations for Southern Bell's provision of enhanced services in the state. Docket No. 3987-U, In Re Southern Bell T&T Co. Cross Subsidy, *Order* (October 1, 1991). The Texas PUC has proposed a prior

(Footnote Continued on Following Page)

preempt any other state safeguards, which we will review, if necessary, on a case-by-case basis.[247]

[7632] 1. *State Structural Separation Requirements*

122. Under our comprehensive set of nonstructural safeguards, the BOCs will be able to offer interstate enhanced services on an integrated basis with interstate basic services, instead of a *Computer II* regime of structural separation. States may decide to require that intrastate enhanced services be provided on a structurally separate basis from intrastate basic services. The *Notice* proposed

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(Footnote Continued from Previous Page)
authorization requirement. Project No. 9547, Telecommunications Privacy Issues, §23.57, *Notice of Proposed Rulemaking* (October 18, 1991). Sufficient factual information has been submitted with respect to these and the other specific state safeguards identified below to warrant a finding of the practical impossibility of complying with these state safeguards while simultaneously integrating interstate basic and enhanced services. Extensive review with states and others has led the Commission to narrow significantly its approach to preemption here. In view of the demonstrated impact on federal objectives of the state actions we are preempting, a further reference to the Joint Conference is not necessary to establish a complete record to decide the issue.

[247] For instance, although the *Notice* sought comment on whether we need to preempt any state nondiscrimination reporting requirements, no commenter urged that we do so. We do not here consider the possible preemption of state regulatory requirements on grounds that they thwart or impede ONA safeguards other than the specific safeguards discussed here. The interrelationship of federal ONA policies and state regulation has been extensively considered in other proceedings. *See* Filing and Review of Open Network Architecture Plans, CC Docket No. 88-2, Phase I, 4 FCC Rcd 1 (1988).

not to preempt a simple state requirement that a carrier establish a separate corporate entity for provision of intrastate enhanced services, but to preempt state requirements for separation of facilities and personnel that it tentatively concluded made it impossible as a practical matter for the BOCs to provide integrated interstate basic and enhanced services. We determine here that state structural separation requirements that apply to purely intrastate enhanced services, or that merely require a separate corporate entity with separate books of account for the intrastate portion of jurisdictionally mixed enhanced services, would not thwart federal objectives. However, we find that state requirements for separation of facilities and personnel used to provide the intrastate portion of jurisdictionally mixed enhanced services would thwart our objectives, and therefore preempt such requirements.

123. The Court in *California* found that the Commission had failed to justify the breadth of its preemption in *Computer III* because the *Computer III* opinion had failed to address the possibility that some enhanced services might be offered on a purely intrastate basis. Based on the record in this proceeding, we do not now think that applying state structural separation requirements to purely intrastate enhanced services would necessarily thwart our objectives for interstate enhanced services. Accordingly, we do not at this time preempt state structural separation requirements applicable to such services.

124. On the other hand, we believe that many, if not most, enhanced services provided by the BOCs, AT&T, and the independents are likely to be

jurisdictionally mixed in nature. For such services, carriers could theoretically take two approaches to accommodating a state requirement for structural separation of facilities and personnel used to provide intrastate enhanced services while at the same time integrating interstate basic and enhanced services. First, in theory, carriers could establish a corporate entity with its own facilities and personnel that would be used to provide all enhanced services and interstate basic services on an integrated basis, and a separate corporate entity with its own facilities and personnel that would be used to provide intrastate basic services. This approach would involve separate facilities and personnel to provide interstate and intrastate basic services. As such, it would be wholly impractical and uneconomical. Many cases have recognized the impracticality of separate [7633] provision of interstate and intrastate basic communications.[248] This approach thus would not enable carriers to provide interstate enhanced services on an integrated basis while complying with state requirements to provide intrastate basic and enhanced services through structurally separate facilities and personnel.

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[248] *California v. FCC*, 905 F.2d at 1243, quoting NARUC v. FCC, 880 F.2d 422, 430 (D.C. Cir. 1989). *See also* Louisiana Public Service Commission v. FCC, 476 U.S. 355, 375 n. 4 (1986); North Carolina Utilities Commission v. FCC, 537 F.2d 787, 791 (4th Cir. 1976), *cert denied*, 429 U.S. 1027; North Carolina Utilities Commission v. FCC, 552 F.2d 1036 (4th Cir. 1977), *cert. denied*, 434 U.S. 874 (197); Atlantic Richfield Co. v. FCC, 3 FCC Rcd 3089 (1988), *affirmed sub. nom.* Public Utility Commission of Texas v. FCC, 886 F.2d 1325 (D.C. 1989); *Illinois Bell Telephone Co. v. FCC*, 883 F.2d 104 (D.C. Cir. 1989).

125. Alternatively, the BOCs could seek to establish a corporate entity with its own facilities and personnel that would be used to provide intrastate enhanced services and essentially retain the facilities and personnel used to provide interstate enhanced services integrated with basic services, interstate and intrastate, within its existing corporate structure. This approach would require that carrier facilities and personnel used to provide the intrastate and interstate portions of an enhanced service be physically separate and duplicated—one set for intrastate enhanced services and one set for interstate enhanced services that would be integrated with interstate basic services.[249]

126. The record demonstrates, however, that this approach is no more operationally feasible than the first approach. As the BOCs assert, for example, it is not possible to market intrastate and interstate enhanced services separately, because customers do not want such services and because it would create great customer confusion to attempt to do so.[250] In

[249] We reject arguments of MCI and others that BOCs do not provide interstate enhanced services because of the interexchange restriction of the *MFJ*. IntraLATA services may be interstate either because the intraLATA service is transmitted by the BOC across state lines or because the service is part of a communication or service transmitted across state lines. It is well established that this Commission has jurisdiction over physically intrastate facilities and services used to provide interstate services. 47 C.F.C. §153(a). New York Telephone Co. v. FCC, 631 F.2d 1059 (2nd Cir. 1980); Southern Pacific Communications, 61 FCC 2d 144 (1974).

[250] NYNEX Comments at 77, 74; BellSouth Comments at 42; SWBT Comments at 64. SWBT states that it has learned from market trials that there is very little market for enhanced services that would be limited to intrastate applications. *Id.* at 64. *See also Illinois Bell Telephone Co. v. FCC*, 883 F.2d 104 (D.C.Cir. 1989).

addition, as is the case in trying to separate interstate and intrastate basic services, duplication of facilities used to provide interstate and intrastate enhanced services is not practically possible because of the many [7634] different facilities involved.[251] Separate general management and operations for the interstate and intrastate portions of a jurisdictionally mixed enhanced service also are not feasible because they would require extremely complex operating procedures for billing and collection, order taking, and service provisioning.[252] Separate installation and maintenance also are not practically possible because there would be great confusion, inefficiency, and difficulty involved in trying to have two corporations locate problems, which are likely to affect both the interstate and intrastate portions of the service.[253] Finally, it is not economically or technically feasible to perform separate research and development. Economically, the potential payback from such activity will be drastically reduced since each corporation will be able to apply the results only to its portion of the enhanced service, rather than the entire service.[254] Technically, implementing the results of separate interstate and intrastate research and development would require the same technical splintering of enhanced services that the courts have

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[251] NYNEX Comments at 72-73; BellSouth Comments at 43.

[252] NYNEX Comments at 74. For instance, a customer wishing to order both interstate and intrastate components of an enhanced service would have to order from two separate companies, and the provisioning of the service would require cumbersome technical and operational coordination by the two corporate entities. Training employees to perform this technical and operational coordination could be very complex.

[253] NYNEX Comments at 76; SWBT Comments at 63.

[254] SWBT Comments at 64.

repeatedly affirmed as infeasible for basic services.[255] In sum, it is not feasible to perform these functions separately for intrastate and interstate portions of an enhanced service. The *Notice* specifically sought comment on whether we could more narrowly tailor our preemption to state structural separation requirements affecting only specific types of facilities and personnel, but no party has suggested any feasible subset of facilities and personnel for preemption.

127. In addition, this second alternative is not feasible because the BOCs may not be able to identify the jurisdictional nature of the use of an enhanced service as it is being provided to the customer, which would be necessary for the BOC to ensure that it is being provided through the appropriate wholly separate corporation.[256] For example, the BOCs do not currently know the origin of any interLATA calls to the voice mail services [7635] they provide their customers.[257] Thus, it would be impossible to route an

[255] *See* note 248, *supra*.

[256] Bell Atlantic Comments at 10-11; BellSouth Comments at 39-40; NYNEX Comments at 64-65; SWBT Comments at 63-64.

[257] No indication of the origin of a call is currently transmitted on interLATA calls except where Automatic Number Identification (ANI) is transmitted. ANI, which is the billing number of the caller, is transmitted from the originating LEC to the interexchange carrier for billing purposes. ANI is not, however, transmitted by the interexchange carrier to the terminating LEC. In any event, ANI provides a billing number, not the caller's telephone number, and therefore does not disclose the caller's location. The only circumstance under which the caller's telephone number is currently available to the terminating LEC is where a call is handled entirely by a single LEC that transmits the Calling Party Number via Signalling System 7 (SS7). Of course, depending on the technical configuration of any enhanced service, even that information might not be sufficient to determine the jurisdiction of an individual call.

incoming call to different voice mail equipment based on jurisdiction. There is, in additon, no record support for the view that it is economically or practically possible to do so.[258] Accordingly, we conclude that it is not practically possible for carriers to integrate the interstate enhanced service if the facilities and personnel of the intrastate enhanced service are subject to state structural separation requirements. As a practical matter state structural separation requirements will compel carriers to use structural separation for interstate services, and, therefore, will negate the federal policy for interstate enhanced services.

128. On the other hand, we are not now persuaded that a state requirement for merely a separate corporate entity with separate books of account for provision of the intrastate component of a jurisdictionally mixed enhanced service would thwart federal objectives. For example, we do not see that carrier personnel maintaining separate accounts for intrastate enhanced services would thwart the opportunity to integrate interstate enhanced services with basic service provision.

[258] If a state imposed structural separation requirements, it would be necessary to know the jurisdiction of each call in order to assure that all intrastate calls were carried over separate facilities. In other contexts, for example, determining whether interstate or intrastate access charge rates apply, it is not necessary to know the jurisdiction of each call, but only to develop a reasonable surrogate for the jurisdictional split of the customer's traffic in aggregate. *See e.g.*, Amendments of Part 69 of the Commission's Rules Relating to the Creation of Access Charge Subelements for Open Network Architecture, Policy and Rules Concerning Rates for Dominant Carriers, CC Docket Nos. 89-79, 87-313, Report and Order and Order on Further Reconsideration and Supplemental Notice of Proposed Rulemaking, 6 FCC Rcd 4524 (1991), paras. 66-68.

129. Because AT&T and the independents are permitted to provide interstate enhanced services on an integrated basis and our public interest objectives would be equally thwarted by state structural separation requirements applied to them, we equally preempt state structural separation requirements that require separate facilities and personnel for the [7636] intrastate portion of a jurisdictionally mixed enhanced service provided by AT&T and the independents. Similarly, we do not preempt requirements applicable to those carriers for a separate corporate entity with separate books of account for provision of the intrastate component of jurisdictionally mixed enhanced services.

2. *State CPNI Rules*

130. Under the CPNI rules we are adopting in this *Report and Order*, BOC personnel with involvement in marketing enhanced service will be able to access a customer's CPNI without prior written authorization, except for customers with more than twenty lines. AT&T and the independents' personnel involved in marketing enhanced services are not subject to any federal prior authorization requirements. Access to CPNI permits effective integrated marketing of enhanced services and permits the efficient use of carrier resources to provide enhanced services to a broad spectrum of customers. Personnel subject to a state prior authorization rule would not be able to access CPNI when it is permitted under the federal rule. Carrier implementation of a state prior authorization rule where it is not required under the federal rule would effectively require the separation of marketing and sales personnel dealing with interstate enhanced

services from personnel dealing with interstate basic services. In these circumstances, the state rule effectively would negate federal policies in favor of achieving the efficiencies and associated public interest benefits of integrated marketing, such as the ability to serve the mass market. Contrary to the assertions of the DC PSC, the fact that a customer may restrict access to its CPNI does not prevent the thwarting of federal policy by state requirements that the carrier obtain prior authorization. Accordingly, we preempt state CPNI rules applicable to the BOCs, AT&T, and independents that require prior authorization whenever such authorization is not required by our rules. Because we are not persuaded at the same time that other aspects of state CPNI rules would thwart or impede federal objectives, we are not preempting such state rules in this proceeding.

3. *State Network Disclosure Rules*

131. Under our network disclosure rules, initial disclosure of network information affecting the interconnection of enhanced service providers is generally required at the make/buy point, *i.e.*, when the carrier decides to make itself, or to procure from an affiliated entity, any product the design of which relies on the network interface. The timing of this disclosure seeks to strike a balance between assuring that independent ESPs receive network information on a timely basis and preventing premature disclosure that could impair carriers' service development efforts and inhibit network innovation. A state rule that required timing of initial disclosure at a time that differs from the federal rule would substitute a state balancing for the federal balancing of these concerns, and could injure company development and network

innovation efforts. While, as suggested by SWBT, states could adopt timing requirements that differed only slightly from the federal rule, carriers cannot simultaneously comply with differing state and federal requirements for initial disclosure of network information given that initial disclosure can occur only once. As stated in the *Notice*, a [7637] state rule that required initial disclosure at a time that differs from the time specified in the federal rule would negate the federal timing because by definition, initial disclosure can occur only once. Accordingly, we preempt state network disclosure rules that require initial disclosure at a time different than the federal rule. We are not persuaded at this time that any state rule that required disclosure of different or broader information would necessarily thwart federal network disclosure rules, and therefore will consider any problems that may arise on a case-by-case basis with other aspects of state network disclosure rules. We additionally do not preempt state network disclosure rules applicable to carriers that are not subject to the federal network disclosure rule.

V. *Ordering Clauses*

132. Accordingly, IT IS ORDERED, that pursuant to authority contained in Sections 1, 4, 201-205, 218, and 220 of the Communications Act of 1934, as amended, 47 U.S.C. Sections 151, 154, 201-205, 218, and 220, Part 64 is AMENDED as set forth in Appendix B.

133. IT IS FURTHER ORDERED, that the policies, rules, and requirements set forth herein ARE ADOPTED.

134. IT IS FURTHER ORDERED, that the Chief, Common Carrier Bureau is delegated authority to act upon matters pertaining to implementation of the policies, rules, and requirements as set forth herein.

135. IT IS FURTHER ORDERED that the decisions in this *Report and Order* concerning removal of structural separation and adoption of nonstructural safeguards including the amendments to Part 64 SHALL BE EFFECTIVE February 1, 1992.[259]

136. IT IS FURTHER ORDERED, that the elimination of the capitalization plan requirement, the prohibition against the regulated BOC company and its affiliates from performing software development for one another, and the prohibition against integrated planning and development IS EFFECTIVE January 1, 1992.[260]

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[259] We order an effective date of February 1, 1992, in order to permit the timely filing of petitions for structural relief by the BOCs on or about February 1, 1992, when federal ONA tariffs are scheduled to become effective. Petitions for structural relief could not be filed on that date unless our establishment herein, see footnote 212, *supra*, of the procedures and preconditions for filing such petitions were effective prior to that date. Accordingly, we find good cause that the effective date should be less than 30 days from publication in the Federal Register. *See* Section 553 (d)(3) of the Administrative Procedure Act, 5 U.S.C. §553 (d)(3).

[260] The publication of a substantive rule which relieves a restriction may be made less than thirty days before its effective date. *See* Section 553 (d)(1) of the Administrative Procedure Act, 5 U.S.C. §553 (d)(1). Our decision to remove the capitalization plan requirement, the prohibition against the regulated BOC company and its affiliates performing software development for one another, and the prohibition against integrated planning and development falls within that provision.

[7638] 137. IT IS FURTHER ORDERED, that the preemption decisions adopted herein SHALL BE EFFECTIVE thirty days after publication of this Report and Order in the Federal Register.

FEDERAL COMMUNICATIONS COMMISSION

Donna R. Searcy
Secretary

[7639]

APPENDIX A

BOC SAFEGUARDS COMMENTS
CC Docket No. 90-623

AccessPlus Communications, Inc. (AccessPlus)
ADAPSO, The Computer Software and Services Industry Association, Inc. (ADAPSO)
Ad Hoc Telecommunications Users Committee (Ad Hoc)
Alarm Industry Communications Committee (AICC)
American Institute of Certified Public Accountants (AICPA)
American Newspaper Publishers Association (ANPA)
American Petroleum Institute (API)
American Public Communications Council (APCC)
American Telephone & Telegraph Company (AT&T)
Ameritech Operating Companies (Ameritech)
Arkansas Public Service Commission; Kansas Corporation Commission; Missouri Public Service Commission; Oklahoma Corporation Commission; Public Utility Commission of Texas on behalf of the Southwest Regional Regulatory Group (SW Group)
Association of American Railroads (AAR)
Association of Telemessaging Services International, Inc. (ATSI)
Bell Atlantic Telephone Companies (Bell Atlantic)
BellSouth Corporation, South Central Bell Telephone Company, and Southern Bell Telephone and Telegraph Company (BellSouth)
California Public Utilities Commission and People of the State of California (California)
California Bankers Clearinghouse Association, New York Clearing House Association, Mastercard International Incorporated, and VISA U.S.A., Inc. (ONA Users Group)

Central Telephone Company (Central)
Cincinnati Bell Telephone (CBT)
Citizens for a Sound Economy Foundation (CSEF)
Colorado Public Utilities Commission (Colorado PUC)
CompuServe Incorporated (CompuServe)
Computer and Business Equipment Manufacturers Association (CBEMA)
Department of Justice (DOJ)
District of Columbia Public Service Commission (DC PSC)
Dun & Bradstreet Corporation (Dun & Bradstreet)
Florida Public Service Commission (Florida PSC)
General Services Administration (GSA)
GTE Services Corporation and affiliated companies (GTE)
State of Hawaii
Illinois Commerce Commission (Illinois Commission)
Independent Data Communications Manufacturers Association (IDCMA)
Independent Telecommunications Network, Inc. (ITN)
Information Industry Association (IIA)
Integrated Communication Systems, Inc. (ICS)
International Business Machines Corporation (IBM)
International Communications Association (ICA)
Iowa Network Services, Inc. (INS)
[7640] MCI Telecommunications Corporation (MCI)
MessagePhone, Inc. (MessagePhone)
Michigan Public Service Commission (Michigan PSC)
National Association of Broadcasters (NAB)
National Association of Regulatory Utility Commissioners (NARUC)
National Telecommunications and Information Administration (NTIA)
National Telephone Cooperative Association (NTCA)

New York Department of Public Service (NY DPS)
NYNEX Telephone Companies (NYNEX)
Oregon Public Utility Commission (Oregon PUC)
Pacific Bell and Nevada Bell (PacTel)
Pennsylvania Office of Consumer Advocate (Pennyslvania)
Rochester Telephone Corporation (Rochester)
Southern New England Telephone Company (SNET)
Southwestern Bell Telephone Company (SWBT)
Stroh Ranch Communications Limited Partnership (Stroh Ranch)
Tele-communications Association (TCA)
Unisys Corporation (Unisys)
United States Telephone Association (USTA)
US Sprint Communications Company Limited Partnership (US Sprint)
US West Communications, Inc. (US West)
Utilities Telecommunications Council (UTC)
Vermont Department of Public Service (Vermont DPS)
Washington Utilities and Transportation Commission (Washington UTC)

[7641] BOC SAFEGUARDS REPLY COMMENTS CC Docket No. 90-623

ADAPSO, The Computer Software and Services Industry Association, Inc. (ADAPSO)
Ad Hoc Telecommunications Users Committee (Ad Hoc)
American Newspaper Publishers Association (ANPA)
American Telephone & Telegraph Company (AT&T)
Ameritech Operating Companies (Ameritech)
Association of Telemessaging Services International, Inc. (ATSI)
Bell Atlantic Telephone Companies (Bell Atlantic)
BellSouth Corporation, South Central Bell Telephone Company, and Southern Bell Telephone and Telegraph Company (BellSouth)
California Public Utilities Commission and People of the State of California (California)
California Bankers Clearinghouse Association, New York Clearing House Association, Mastercard International Incorporated, and VISA U.S.A., Inc. (ONA Users Group)
CompuServe Incorporated (CompuServe)
District of Columbia Public Service Commission (DC PSC)
General Services Administration (GSA)
GTE Service Corporation and affiliated companies (GTE)
State of Hawaii
Independent Data Communications Manufacturers Association (IDCMA)
Information Industry Association (IIA)
Integrated Communication Systems, Inc. (ICS)
McGraw-Hill, Inc. (McGraw-Hill)
National Cable Television Association, Inc. (NCTA)

National Telephone Cooperative Association (NTCA)
NYNEX Telephone Companies (NYNEX)
Oregon Public Utility Commission (Oregon PUC)
Pacific Bell and Nevada Bell (Pacific)
Southern New England Telephone Company (SNET)
Southwestern Bell Telephone Company (SWBT)
Tele-communications Association (TCA)
Texas Public Utilities Commission (Texas PUC)
United States Telephone Association (USTA)
US Sprint Communications Company Limited Partnership (US Sprint)
US West Communications, Inc. (US West)

[7642] **APPENDIX B**

Amendments to the Code of Federal Regulations

Title 47 of the C.F.R., Part 64, is amended as follows:

Part 64—Miscellaneous Rules Relating to Common Carriers

1. The authority citation for Part 64 continues to read as follows:

Authority: Sec. 4, 48 Stat. 1066, as amended; 47 U.S.C. 154. Interpret or apply secs. 210, 218, 48 Stat. 1070, as amended, 1077; 47 U.S.C. 201, 218.

2. New Section 64.903 is added to read as follows:

64.903 Cost Allocation Manuals

(a) Each local exchange carrier with annual operating revenues of $100 million or more shall file with the Commission a manual containing the following information regarding its allocation of costs between regulated and nonregulated activities:

(i) A description of each of the carrier's nonregulated activities;

(ii) A list of all the activities to which the carrier now accords incidental accounting treatment and the justification therefor;

(iii) A chart showing all of the carrier's corporate affiliates;

(iv) A statement identifying each affiliate that engages in or will engage in transactions with the carrier and describing the nature, terms and frequency of each transaction;

(v) A cost apportionment table showing, for each account containing costs incurred in providing regulated services, the cost pools within that account, the procedures used to place costs into each cost pool, and the method used to apportion the costs within each cost pool between regulated and nonregulated activities; and

(vi) A description of the time reporting procedures that the carrier uses, including the methods or studies designed to measure and allocate non-productive time.

(b) Each carrier shall ensure that the information contained in its cost allocation manual is accurate. Carriers must update their manuals at least quarterly, except that changes to the cost apportionment table and to the description of time reporting procedures must be filed at least 60 days before the carrier plans to implement the changes. Proposed changes in the description of time reporting procedures, the statement concerning affiliate transactions, and the cost apportionment table must be accompanied by a [7643] statement quantifying the impact of each change on regulated operations. Changes in the description of time reporting procedures and the statement concerning affiliate transactions must be quantified in $100,000 increments at the account level. Changes in cost apportionment tables must be quantified in $100,000 increments at the cost pool level. The Chief, Common Carrier Bureau may suspend any such changes for a period not to exceed 180 days, and may thereafter allow the change to become effective or to prescribe a different procedure.

(c) The Commission may by order require any other communications common carrier to file and maintain a cost allocation manual as provided in this section.

(3) New Section 64.904 is added to read as follows:

64.904 Independent Audits

(a) Each local exchange carrier required by this Part or by Commission order to file a cost allocation manual shall have performed annually, by an independent auditor, an audit that provides a positive opinion on whether the applicable data shown in the carrier's annual report required by Section 43.21(f)(2) of this Chapter presents fairly, in all material respects, the information of the carrier required to be set forth therein in accordance with the carrier's cost allocation manual, the Commission's Joint Cost Orders issued in conjunction with CC Docket No. 86-111 and the Commission's rules and regulations including Sections 32.23, 32.27, 64.901 and 64.903 in force as of the date of the auditor's report. The audit shall be conducted in accordance with generally accepted auditing standards, except as otherwise directed by the Chief, Common Carrier Bureau.

(b) The report of the independent auditor shall be filed at the time that the local exchange carrier files the annual report required by Section 43.21(f)(2) of this Chapter.

[7644] November 21, 1991

SEPARATE STATEMENT OF COMMISSIONER ERVIN S. DUGGAN

In Re: *Computer III Remand Proceedings: Bell Operating Company Safeguards and Tier 1 Local Exchange Company Safeguards*

I have decided, after carefully weighing the arguments favoring nonstructural safeguards—and despite lingering concerns about the adequacy of such safeguards—to join my fellow Commissioners in voting to rely on nonstructural safeguards for Bell Operating Company provision of enhanced services.

I am persuaded that allowing the Bell Operating Companies to provide enhanced services on an integrated basis does promise significant public interest benefits. Those benefits are sufficient, in my mind, to outweigh the costs of forgoing the protections of structural separation. Integrated operations generate cost savings that if passed on to the consumer could provide real public benefits. In particular, it appears that the cost savings derived from joint marketing of enhanced and basic services may mean that the BOCs can provide affordable enhanced services to the mass market that others may not be able to provide profitably. Voice messaging is an obvious example.

We are heading, nevertheless, into uncharted territory. The MFJ restriction has only recently been lifted. As technology [7645] and its applications evolve, the enhanced services marketplace will develop in ways that are not easy to predict. Open

Network Architecture, too, is an evolving process; we do not yet have experience with federally tariffed ONA services.

So in the end, my decision to support this item rests upon one important feature: a pledge by the Commission, included in the order we adopt today, to review the effectiveness of nonstructural safeguards after three years. We will determine in that three-year review proceeding whether our nonstructural safeguards have in fact been effective in protecting against discrimination and cross-subsidies. If we find after three years' experience that nonstructural safeguards have not succeeded, then I presume we will not hesitate to reimpose whatever structural separation requirements appear necessary.

It seems to me essential for travelers heading off into uncharted territory to take along safety equipment and to devise ways to retrace their steps if they take a wrong turn. The three-year review proceeding offers both. It will give us a chance to test empirically the Commission's predictions about the efficacy of our safeguards and the public interest benefits of integration. And it gives us at least some chance to correct any mistakes we might find that the Commission has made in its enthusiasm for nonstructural safeguards.

# # # #

TRANSCRIPT OF PROCEEDINGS BEFORE THE SUPREME COURT OF THE UNITED STATES

(January 13, 1986)

[1] IN THE
SUPREME COURT OF THE UNITED STATES

LOUISIANA PUBLIC SERVICE COMMISSION,
Appellant,

v.

FEDERAL COMMUNICATIONS COMMISSION, ET AL.;

No. 84-871

CALIFORNIA AND PUBLIC UTILITIES COMMISSION OF CALIFORNIA, ET AL.,
Petitioners,

v.

FEDERAL COMMUNICATIONS COMMISSION AND UNITED STATES;

No. 84-889

PUBLIC UTILITIES COMMISSION OF OHIO, ET AL.,
Petitioners,

v.

FEDERAL COMMUNICATIONS COMMISSION, ET AL.;

No. 84-1054

---

[2] And

FLORIDA PUBLIC SERVICE COMMISSION,
Petitioner,

v.

FEDERAL COMMUNICATIONS COMMISSION, ET AL.

No. 84-1069

Washington, D.C.
Monday, January 13, 1985

The above-entitled matter came on for oral argument before the Supreme Court of the United States at 12:59 o'clock p.m.

APPEARANCES:

LAWRENCE G. MALONE, ESQ., Assistant Counsel, New York Public Service Commission, Albany, New York; on behalf of the appellant and petitioners.

CHARLES FRIED, ESQ., Solicitor General, Department of Justice, Washington, D.C.; on behalf of the federal parties.

MICHAEL BOUDIN, ESQ., Washington, D.C.; on behalf of AT&T and the former Bell System Operating Companies.

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[4] PROCEEDINGS

CHIEF JUSTICE BURGER: We will hear arguments next in Louisiana Public Service Commission against the Federal Communications Commission and related cases.

Mr Malone, you may proceed whenever you are ready.

ORAL ARGUMENT OF LAWRENCE G. MALONE, ESQ., ON BEHALF OF THE APPELLANT AND PETITIONERS

MR. MALONE: Mr. Chief Justice, and may it please the Court, this is a consolidated case. It is here on three petitions for writs of certiorari to the Fourth Circuit Court of Appeals. They have been brought by California, Ohio, and Florida. And there is a separate appeal which has been instituted by the state of Louisiana.

The issue raised by these cases is whether the 1934 Communications Act empowers the FCC to preempt the state's regulation of depreciation in accounting matters for local telephone ratemaking purposes.

From 1934 to 1983, the FCC did not attempt to preempt. It took the position that the Act as written deserved a system of dual, that's state and federal regulation over these matters. So this dual regulation took hold, and a primitive telephone network eventually became the most technologically advanced, efficient, and [5] reliable system in the world.

Then in 1983 the Commission took a new position. It found at the behest of the utility industry that the Act as originally written not only allowed but required preemption, and that even if its new reading of the Act was inaccurate, it still could preempt because a failure to do so would frustrate the implementation of its general responsibility to maintain an efficient interstate telephone network.

So it told the states to base local rates on its perception of the correct way to depreciate and to account for the costs in plant which are assigned to the states under the long accepted separations principle.

Now, that decision, if upheld by the courts, will require local telephone customers to pay very substantial telephone rate increases with no assurance that a single dollar of those added payments will go to fulfilling the purpose for which the FCC preempted. That is, plant modernization.

On appeal, the lower court, the Fourth Circuit, had affirmed by a two to one vote, and it has done so based not on agreement with the Commission's new reading of the Communications Act, but rather on this implied preemption theory, the syllogism that competition will breed a need for plant replacement or accelerated [6] depreciation, and that can be facilitated by preemption.

The lower court should be reversed for several reasons. The first is that it ignores the will of Congress. It ignores the fact that Congress back in 1934 carefully constructed a jurisdictional boundary which divided the FCC's jurisdiction from that of the states, and in doing so preserved to the states local depreciation and accounting regulation.

Now, depreciation by definition is the recovery of a capital asset over its life. So in sitting down to set up depreciation accruals, a company manager or a regulator asks him or herself three questions. Is this cost or is this asset depreciable? That is, they classify the property.

The second question is, what is it worth? What is its value? That is the valuation of the property. And the third question is, how long is this going to live, because I want to allow the company to recover this capital value over its life, and that is the process that results in the calculation of a specific depreciation percentage.

QUESTION: That is straight line depreciation.

MR. MALONE: That is straight line depreciation, Your Honor.

Now, having developed this percentage, you then [7] simply apply that to the capital asset and derive specific dollar and cent depreciation charges to recover each year.

The fundamental flaw with the FCC's position that it is able to preempt and able to set local depreciation charges is that each of these three functions, each tool involved in this task has been denied the FCC by Congress.

First, let's look at valuation. Section 213 of the Communciations Act empowers the FCC to value plant, but Section 213(h) expressly and unequivocally provides that the states retain the power to value the plant which is under their jurisdiction.

So, certainly if the FCC cannot dictate to the states the value of the plant which is subject to intrastate regulation, then they can't dictate the specific depreciation accruals which are designed to reimburse companies for the value of that plant.

In other words, the FCC order assumes unto itself a power expressly denied it by Section 213(h). Let's look at the other two functions, classification of the property and the development of these specific depreciation percentages to apply to the property's value.

Well, the government, the FCC argues that [8] Section 220(b) of the Act, and that is the general depreciation and accounting section, gives them the authority not only to set up classifications and these specific depreciation percentages for the plant under their jurisdiction, but it also gives them the authority to set up classifications and percentages for the plant and the assets under the state's jurisdiction and

authority. That is the new reading. That is the reading that they never took from 1934 to 1983, and that the Fourth Circuit was not willing to embrace.

But they argue that Section 220(b) expressly authorizes them to take over these two functions, but when one reads Section 220 in its full context, with particular reference to Section 220(j), one sees that Congress did not give them the authority to classify plant or to develop depreciation percentages with respect to the plant in the state's jurisdiction.

Now, of course, this is—

QUESTION: Mr. Malone, what kind of physical plant or equipment are we talking about? Is it telephone instruments?

MR. MALONE: It could be telephone poles, Your Honor, telephone lines, all of the plant which really goes into—the vast majority of the plant which goes into the provision of telephone service. Certainly there [9] is a certain amount of plant which is assigned solely to the provision of intrastate service, but what we are dealing with here is the FCC's attempt to take over the costs mainly which are devoted to jointly used plant.

QUESTION: And jointly used plant means plant whether it is telephones or lines or both that are used for both intrastate and interstate?

MR. MALONE: That's correct, Your Honor.

Now, if one considers the fact that in 1934 the vast majority of this plant was valued on a fair value basis, and fair value is attune inextricably to the length of lives, it really makes no sense that Congress

would have ever told the states that you can value the plant but say to the FCC with the states valuing it, you can assume how long it is going to live.

That is like asking two people to drive a car at one time with one person having their foot on the accelerator and the other person steering. It just couldn't possibly work.

But the FCC here is saying that it has the power to classify this property, and really its position misreads Section 220(j). Now, that was a provision, Your Honors, which caused a great deal of dispute in the enactment of the Communications Act.

The Senate wanted a 220(j) which would have [10] assumed preemptive powers with the FCC, and would have called for a study to look into the reasonableness of undoing these powers, and the House wanted a 220(j) which would have expressly prohibited preemption.

So, a conference committee was called, and it ultimately gave both sides part of the loaf. It gave the House the continuation of the status quo, which in 1934 was dual regulation with the states regulating these depreciation and accounting functions for local matters, and it gave the Senate a direction, not a request, but a direction to the FCC to study this dual regulation, and to come back and tell us whether it works.

If it is causing problems, do a study—whether it is causing problems or not, do a study, and come back to us, and if it is causing problems we will give you new legislation to give you preemptive authority.

But 220(j) clearly evidences Congress's position that the act as written left the states with this power because it envisions a need for new legislation to harmonize what it describes as state and federal powers, not practices, but powers over depreciation in accounting matters.

So, the three functions, the classification of the property, its valuation, and the development of [11] specific depreciation percentages to apply to that value in order to determine dollar and cents accruals are all reserved to the states.

QUESTION: Well, Mr. Malone, one section you rely rather heavily on, I guess, is 152(b), and that talks about prohibiting Commission jurisdiction over charges, classifications, et cetera, in connection with interstate communications service.

Now, when you have got a telephone pole out there that has wires on it that are used both for intrastate and interstate, do you say that that section means that you allocate a part of that pole to intrastate service?

MR. MALONE: Yes, Your Honor, but I think Congress has always recognized, Your Honor, that if you have a telephone pole in Lake Tahoe, it is subject to a very different climate than a telephone pole in Lake Placid, and it is—

QUESTION: Are either one of them on dry land, I presume?

MR. MALONE: Yes, Your Honor.

(General laughter.)

MR. MALONE: But one is not going to last as long as the other. By the same token, if you have a central office switch serving an area such as Tampa

Bay, [12] which is growing, and a central office switch serving an area such as Green Bay, they are subject to very different technological obsolescence, growth, very different factors that go into the development of these service lives and these depreciation percentages.

And Congress back in '34 wisely recognized that the state regulators on the scene were best able to take measure of these differences and to set meaningful depreciation charges in accounting classifications.

QUESTION: Did the Commission then allow the states or did it follow the states' methods when it came to depreciating for interstate communications service?

MR. MALONE: Well, for interstate communications services, the Commission eventually grew into a position where it was able to develop its own depreciation charges with respect to the costs that were separated to it.

Let's assume we have a telephone pole that costs $100, and we assume that 75 percent of that pole's usage is devoted to intrastate services and 25 percent is devoted to interstate. What we do is, we assign the states responsibility for dealing with the $75 on that pole, and the FCC is responsible for dealing with the other $25.

QUESTION: So the allocation is between a [13] percentage of value of a single physical entity.

MR. MALONE: That's right, Your Honor. That's correct. And with respect to Section 152, Your Honor, that is a jurisdictional overlay to the act. It tell us how to read the other provisions.

Subdivision (a) assigns the FCC jurisdiction of interstate matters, and subdivision (b) tells the FCC and the states what the FCC can't do. Subdivision (b), which you referred to, Your Honor, prohibits the FCC from asserting jurisdiction over charges, classifications, and practices devoted to the provision of intrastate services.

So, clearly the threshold question with respect to that provision is, do these terms, charges, classifications, and practices refer to local or intrastate matters? Because if they do, the FCC is violating 52(b) as well as 213(h) and 220(j).

Now, charges, classifications, and practices traditionally have been used to refer to depreciation charges or classification and accounting classifications or practices. Congress in fact in Section 220, which is the lynchpin for the FCC's preemption theory in this case that general depreciation and accounting statutes uses the term "charges" seven times to refer to depreciation, and it used the term "classifications" to refer to [14] accounting.

Academicians, state regulators, the utility industry, the FCC, and before it the ICC have all consistently used these terms found in Section 152(b) to refer to depreciation and accounting. So, I don't think there is any question that if we read 152(b) consistently with its general usage, that it prohibits preemption by preserving to the states and to their jurisdiction regulatory control over local depreciation charges and accounting classifications.

But how does the FCC—how does it answer these claims? How did the Fourth Circuit answer them? Well, the Fourth Circuit did not give a great deal of attention to the law because it went on to Section 151 and the implied preemption theory.

But on appeal, the respondents have argued that Section 152(b), although by its express design it refers to all of Title 2 other than the pole attachment statute, and therefore would refer to Section 220, and although Section 152 uses the very same terms as appear in Section 220, they argue that it has no relevance to depreciation accounting.

They claim that the terms charges, classifications, and practices refer to rate structures or rates for services, but their position ignores the [15] fact that that statute used very different language than Congress had intended to just refer to rates for services.

It says that the FCC cannot assert jurisdiction over charges, classifications, and practices for or in connection with local rates, and it is the in connection with language which clearly encompasses depreciation and accounting.

Their position also in claiming that it has no reference to 220 and simply refers to rate structure attributes extreme redundancy to Congress by assuming that Congress used six terms to mean one.

With respect to Section 220(j), and that is the provision again which calls for a study by the FCC to look into the reasonableness of harmonizing state and federal powers over depreciation, they argued that that provision was nothing more than a paraphrase of the Senate pro-preemption 220(j).

But again, that statute belies their position, because it calls for the harmonization of state and federal powers, and clearly by calling for the harmonization of powers, it assumed that the states did have powers under the law as written, a position directly contrary to that which formed the basis for the preemption order.

[15] With regard to Section 213(h), they haven't answered us, and frankly, we can't criticize them for not doing so, because our position on that evolves from our analysis of allegations made by the respondents in their briefs concerning Section 213(h), GTE in particular, so they haven't had an opportunity to respond on that.

But we have here two very different readings of the Communications Act. We have a reading by the states which, of course, is consistent with the reading that the FCC took for its first 50 years which has all of the pieces of the legislative puzzle fitting. They are structurally coherent. They supplement one another.

Each word in each statute has a meaning, and we had the respondents' reading, the new reading, which has pieces in the legislative puzzle clashing. They conflict. You have Section 152(b) referring clearly to other provisions of the Act, including Section 220, but under their position having no relevance to Section 220.

You have six terms of art in Section 152(b), according to their position, meaning only one term. You have Sections 220(h), referring to waivers, and Section 220(i), a notice statute, as proposed by the states, directly at odds with Section 220(j) as originally proposed by the states.

In other words, their new reading of the Act [17] violates a number of rules of statutory construction, but the Fourth Circuit was still willing to preempt, and it did so by reasoning that even though this increase or this order by the FCC is really designed to increase local rates, that is still justified because it is going to further general responsibilities found in Section 151 of the Act.

But that sort of reasoning, as the lower court dissent indicated, really allows an agency to overreach with its general purpose language. It invites an agency to hold general purpose language such as 151, which really has no legislative history to it, and simply tells the FCC, go and regulate interstate matters, to hold that language up to the light and to manipulate it until it is able to derive a stream of unstated purposes which are really predesigned to conflict with the state law to be overridden.

And that process is particularly bothersome when it overrides historic, deeply routed police powers which preexisted with the states at that time that the Communications Act was passed. We don't think that this Court has ever endorsed this sort of stepping stone or bootstrap preemption.

Indeed, in the Pacific Gas and Electric Case, this Court indicated where Congress has clearly evidenced [18] a willingness to tolerate dual regulation, there is no basis for implying preemptive authority in an agency to preempt in order to avoid the effects of the dual regulation which Congress has indicated a willingness to live with.

What we have in this case is a classic example of—

QUESTION: I think the thrust of your argument is that there just isn't any room under the Act for any kind of an implied preemption. It is just contrary to the express terms of the Act.

MR. MALONE: Exactly, Your Honor. Exactly. What we have here is, we have an Act of Congress which clearly sets up dual regulation, which constructs this jurisdictional wall between the states and the federal government, and then we have an

administrative order which simply circumvents that wall, and it is based not on new law, or it is based not on the study which was called for by Congress, but simply on the FCC's adoption of an agency argument that competition had triggered a need for accelerated depreciation, which triggered a need for preemption, and that argument ignores—

QUESTION: I take it you would be making the same argument even if you accepted, which I gather you don't, that dual regulation permitting the states to set [19] depreciation rates for interstate, intrastate equipment would frustrate the FCC's powers.

MR. MALONE: We would make the same argument, Your Honor—

QUESTION: Yes.

MR. MALONE: —and you are right, we do not accept that assumption which is the basis for the FCC's action. We don't accept that assumption for several reasons, one of which is that depreciation is but one of many factors, and it is far down the list on the list of factors which affect a management's decision to modernize plant or to replace it.

Certainly rate of return, the trading value of stock, interest rates, and all of these other factors are much more important in the equation, and if the FCC is allowed to preempt on a deeply routed police power based upon this guise of plant modernization which it was able to derive from its general responsibility by the power of its imagination, then where do we draw the line? What can't it preempt?

What the FCC is really doing by asking the Court to adopt this general responsibility language as a gateway to preemption is inviting a trolley ride. It is

one way. It has no brakes on it. And it is destined inevitably to result in the dissolution of dual [20] regulation.

But Section 220(j) of the Act tells the FCC that if it has problems with dual regulation, it isn't to do away with it by administrative order. It is to do a study and make its case to Congress.

But the FCC hasn't made its case to Congress, and it hasn't asked for new legislation. It has simply taken unto itself an attempt to expand its jurisdictional guidelines. We think that the Fourth Circuit has clearly erred in endorsing that order, and that it should therefore be reversed.

QUESTION: I've got a little bit of confusion over one of your figures of speech, your analogies. You use the analogy of someone handling the steering wheel and someone else on the accelerator and the brakes. It cuts against you a little bit here, doesn't it?

MR. MALONE: No, Your Honor, because what that analogy refers to is the fact that—let me explain what the analogy meant, and then why I don't think it cuts against us at all.

By the analogy I was referring to the fact that the FCC is attempting to tell the states, in fact the very purpose of its order is to tell the states what dollar and cent depreciation accruals have to be included in local rates. Now, Section 213(h) preserves to the [21] states the power to classify property or the power to value property, and the valuation of property—picture yourself attempting to determine what a telephone pole is worth under a fair value jurisdiction, which was the brunt of the jurisdiction back in 1934.

One question you would ask yourself is, how long is it going to last? Their position is that the states can go out—well, they haven't conceded this, but Section 213(h) clearly provides that the states would go out and ask that question, how long is it going to last, to determine the value, but that the FCC would come in and tell them how long it is going to last for the purpose of developing depreciation charges.

And that is inconsistent, and that is what I meant when I referred to one person on the accelerator and the other person on the wheel. You wouldn't be able to develop depreciation charges that way. It wouldn't work.

I think the implication of your question, Your Honor, is, if we have two different bodies setting depreciation charges for one telephone pole, don't we have one person on the pedal and another person on the wheel, and the answer is no because Congress, I think, correctly recognized that you can easily separate the costs, and then each jurisdiction can deal with the costs [22] under its power for the purpose of developing local rates and allowing capital recovery.

And 47 years of history demonstrate that the process has worked extremely well.

QUESTION: Mr. Malone, if you should not prevail here, how much of a disaster really is it to the state?

MR. MALONE: Well, Your Honor, I think there would be disasters in two forms. One would be the immediate rate effect, which we estimate at about a billion dollars a year that local customers would have to bear in rates, and the problem—

QUESTION: Because of accelerated depreciation?

MR. MALONE: Because of the ELG and the remaining life concepts, which would be forced onto states by the FCC. It would be about a billion dollars a year. And as the—

QUESTION: Countrywide?

MR. MALONE: Yes. In New York we estimate the effect for this year would be about $120 million, Your Honor, and the problem with that is the brief, the amicus brief of TRACER, the Telephone Ratepayers for a Cost Based and Equitable Rates, which was a business association of business users of telephone service, [23] points out that that rate increase, which the Department of Defense indicated below would not be justified and wouldn't really serve any purpose, would have the effect of causing business customers to try to get off the network, and that would lead to investment which was out there—it wouldn't be serving anybody—called stranded investment, which would force other rates upward. You would have a spiraling effect, self-perpetuating, which would then force other people off the system, all based upon the FCC's application of a broad brush to a set of circumstances really requiring a fine stroke.

We may have competition out there. We do. And the states recognize that. And we are willing to deal with that in the development of depreciation charges, but certainly you don't have the same competition in Peoria that you do in Houston, and it is the regulators in those states who are best able to evaluate this competition and determine its effect on depreciation lives.

So, the first effect would certainly be increased rates, and that would be deleterious to the states.

The second effect, Your Honor, that we are concerned with is, if the FCC is upheld, where does that lead us? If it is able to preempt depreciation and [24] accounting based upon this broad-gauged approach of plant modernizing, which isn't even set forth in the Act, why can't it then attempt to preempt all of the factors on the list of relevance to plant modernization which are above depreciation, such as rate of return and other factors which are again an integral part of state regulation?

Thank you, Your Honor.

QUESTION: Of course, a good bit of it, that is, the federal system will—on your approach will increase rates, too, does increase rates.

MR. MALONE: If the FCC takes action simply for the—

QUESTION: For the interstate.

MR. MALONE: Yes.

QUESTION: And has it in fact driven away customers into other areas?

MR. MALONE: With respect to interstate usage?

QUESTION: Yes.

MR. MALONE: Oh, yes, there is no question there has been bypass which has resulted from rate increases.

QUESTION: And the Republic hasn't come to an end.

MR. MALONE: The Republic hasn't come to an [25] end, Your Honor, no.

Thank you.

CHIEF JUSTICE BURGER: Mr. Solicitor General.

ORAL ARGUMENT OF CHARLES FRIED, ESQ., ON BEHALF OF THE FEDERAL PARTIES

MR. FRIED: Thank you, Mr. Chief Justice, and may it please the Court, I should first begin by making a remark about the effect on rates.

In the Maryland case, which is the case which you will be considering immediately after this, the Fourth Circuit Court of Appeals at Page 8 of the cert petition—Page 8A of the appendix to the cert petition estimated that the effect on rates was on the average a penny a day per customer, and there is no reason to suppose that Maryland is unusual in this respect.

Our affirmative argument is straightforward, so I would like to just set the predicate for it, and then move on to some of the concerns that have been raised by petitioners and others.

The basis for federal intervention here is, I think, rather palpable. We are talking about maintaining—

QUESTION: Mr. Fried, excuse me for interrupting, but I just was turning around in my mind here your opening remarks as a response to his figure, I [26] guess it will be a billion dollars or something. You are saying, well, in Maryland it is only a penny a day. Are you disagreeing with his overall figure, or are you just saying it isn't very much in Maryland?

MR. FRIED: I don't know quite how to deal with that overall figure. It is an estimate. I don't know of any finding to that effect, and when we are talking about telephone rates nationwide, I am not able on the spur of the moment to decide whether a billion dollars is a lot or a little, but I don't want to concede—

QUESTION: That is why I didn't know how you got a penny a day, either.

MR. FRIED: I don't want to concede that billion dollars. I thought the penny—a penny a day was a—

QUESTION: What does a penny a day translate into in dollars per year for the whole state? Do you know?

QUESTION: Sixteen million.

MR. FRIED: I can't tell you that.

QUESTION: There are four million people in Maryland. You figure $4 a year, you are talking about $16 million in Maryland on your figures.

MR. FRIED: And perhaps that way we can begin to approach Mr. Malone's figure, and we are both right.

[27] QUESTION: Well, there—

(General laughter.)

QUESTION: There seems to be some difference between the effect in New York and the effect in Maryland if you are both right. Maybe it is the Mason-Dixon line.

(General laughter.)

MR. FRIED: Well, perhaps my brother, Mr. Boudin, can assist on some of these matters, but I do want to call the Court's attention to the findings of the Court of Appeals in the Maryland case, because there there is a specific finding which brings the matter down to the effect on consumers.

Now, we are talking about the physical integrity and the modernity and the financial soundness of the very channels of interstate communication, and what depreciation is about is paying for physical equipment as it wears out, technologically or physically.

And all that the preemption order sought to do is to make sure that the preemption calculations were made in as accurate a fashion as possible, and that is very important.

QUESTION: The what, the preemption calculation?

MR. FRIED: I am sorry, the depreciation [28] calculations, Justice White, that the depreciation calculations were made in as accurate a way as possible, that they reflected as accurately as possible what in fact was happening to those assets out there in the world.

Now, all of these assets are used both in inter and intrastate communications because, as Justice Burger said when he was on the D.C. Court of Appeals, in terms of facilities, we have one integrated system, and when the switch fails in a local exchange or a telephone pole which is rotted blows down, the effect is as much on interstate as it is on intrastate communications.

Now, the basis for what the FCC did here is, as Mr. Malone pointed out, first of all in Section 1 of the Act, Section 151, in which the FCC has an overriding mandate to make available to all the people of the United States rapid, efficient nationwide facilities at reasonable charges, and Section 220(b), which says that the Commission shall prescribe depreciation charges. Those are the two statutory bases.

Now, let me address some of the concerns that have been raised apart from the concerns about rate increases. First, there is a very real concern about federalism. It is an important concern. It is one that we share.

[29] But here, unlike some other cases the court has had to consider, there is no setting of the state's regulatory agenda, no mandating of state procedures, as one Justice has put it, no kidnapping of the state procedures at all, just the familiar instance of federal law supplying one of the determinants in an element in a calculation which otherwise goes forward wholly according to state procedures and concerns.

QUESTION: But, Mr. Fried, your opponent argues, and I would be interested in your response to this, but if you could take care of this one element, what about all the other elements, such as rate of return, and rate base, and other factors that go into rate? Could you take over those as well?

MR. FRIED: Well, in this case, though the Court of Appeals spoke in terms of Section 1, the Commission was very assiduous to rely on Section 220(b), which specifically spoke about depreciation.

So, if there is a slippery slope here, the FCC has not sought to put its foot on it. It has rested firmly on Section 220(b). Now, Section 152(b) is—2(b)(1) is the one which causes most difficulties for the petitioners.

And here I must say we read the legislative history rather differently from petitioners because what [30] we see happening, happened back there in 1934 was that the state commissioners were alarmed about federal intervention in depreciation, and sought from the House a provision, 220(j), sought a 220(j) which would block any federal effect on intrastate depreciation rates, and they failed to get that provision.

What they got seems to me to look like a typical face-saving compromise which gave them some sort of compromise language, but not at all the substance of what they were seeking.

Now, the language also of 152(b) does not do what petitioners claim. The petitioners read 152(b) as if it said, if you have a facility which exists in both interstate and intrastate communication, then the fact that it exists in intrastate communication precludes federal jurisdiction over it.

That reading is a reading which has been consistently urged upon the commission and consistently rejected. It was first urged and first rejected back in 1947, when the Commission began its long trek towards the situation which now obtains where you can buy your telephone rather than having to rent it from the phone company.

And what the Commission did to bring about that result, and of course it doesn't obtain just in respect [31] to the telephone you have in your home, but it

relates to private exchange systems, to all kinds of complicated computer equipment and the like.

What the Commission did was to mandate that the state commissions remove from their tariffs any requirement that customers pay for and lease their phones from the phone company. Now, that telephone, which you now can buy because of the FCC orders, that telephone is used 97 percent, it is estimated, in intrastate communication, yet the remaining 3 percent is crucial to interstate and was found to be sufficient for a federal regime about customer terminal equipment.

QUESTION: Ninety-seven percent of intrastate and three—

MR. FRIED: Most—yes—

QUESTION: —percent in interstate?

MR. FRIED: Yes, Justice Rehnquist. Most—the telephone you use in your home probably is used 97 percent intrastate, and the regime which now obtains is a regime that was imposed by the FCC against exactly the same 2(b)(1) argument that you are hearing today. The regime which has been imposed on the transmission of—

QUESTION: Mr. Solicitor General, that regime wasn't imposed pursuant to 220(b), was it?

MR. FRIED: No, it was—

[32] QUESTION: That is what really raises my question that you answered before by saying, well, the Commission has merely acted pursuant to 220(b) here. But if they are right on 220(b) and the one involving the use of the phone, why couldn't they also use the same argument or 220(a) to prescribe rates of return and capital investment and all the rest?

MR. FRIED: As we read, as we read—

QUESTION: First, let me ask you, do you think they could?

MR. FRIED: I think that would be a long stretch, and a very serious move which I would not—

QUESTION: That is a matter of—

(General laughter.)

MR. FRIED: —which I would—I myself would be very hesitant to embrace, because if you see what remains, Justice Stevens, and I think the question really points out what this case is about, because if you see what remains of the states' capacity here, what they are left with is that part which is peculiarly appropriate to state concern, the rate design questions.

For instance, will businesses subsidize residences? Will large users subsidize small users? Are we going to have lifeline rates? Are we going to have special rates for low income users? All of these things [33] are exactly the kinds of things which are—

QUESTION: They have said that depreciation was one of those things for the last 50 years, too, but then the FCC has now taken a different view, and might it also not take a different view of rate of return, capital investment, and all the rest?

MR. FRIED: I think that depreciation with respect is not one of those things. Depreciation—

QUESTION: Well, it is true that the states have done it for themselves for 50 years, is it not?

MR. FRIED: I think that that is a rather—

QUESTION: At least as to intrastate components.

MR. FRIED: I don't think that can be affirmed wholeheartedly, Justice Stevens, because in fact what has been happening for the last 50 years on depreciation rates is that they are set in three-way meetings between the FCC, state commissioners, and the telephone companies, and at the end of those three-way meetings a depreciation rate is set by the FCC, and by and large it is followed.

Now, what has not happened is that—

QUESTION: Did that necessarily govern the depreciation rate for purely intrastate facilities?

MR. FRIED: It has so far. Yes, Your Honor. [34] Yes, it has. Now, it has never come to a conflict. Those three-way meetings have by and large—I can't say universally, but by and large been the basis for depreciation rates throughout the country, and those are meetings with those three components leading to the setting of a rate by the FCC.

There has been one reported case in which there was resistance to that, and the state court decision which held, as Mr. Malone has argued, but beyond that, the universal practice has been one of accommodation, no particular conflict, under the aegis and leadership of the FCC.

QUESTION: Well, it was working so well, what was the reason for a change?

MR. FRIED: The reason for the change is the reason which the Commission gave, which is that in the new technological and competitive environment, the inaccurate depreciation formulas, the whole life

formulas and the vintage group formulas, and that is what we are talking about, that is all we are talking about here, and essentially those are formulas which have to do—at least the whole life formulas have to do with how you adjust to misestimates.

QUESTION: So it didn't think the three-way meeting would accomplish what it wanted to accomplish?

[35] MR. FRIED: I think that what happened—

QUESTION: And why not?

MR. FRIED: What happened was, in the first—the first depreciation order, the one which—where the Commission has departed from that, they assume that the states would go along, and there had been this kind of collaboration.

What happened, and this is set out in Footnote 14 of Paragraph 37 of the FCC's order, to their surprise, for the first time 14 states refused to follow them on one element of the depreciation order, and nine on another. So, for the first time, the FCC was faced with a real confrontation, a confrontation which had not existed until this time.

Now, if I may go back, Justice Stevens, to your question, because I think it is an important one, there is a big difference between depreciation on one hand and these rate design questions on the other.

QUESTION: Yes, I would suppose that one could argue that rate of return is something of national interest, and on a nationwide basis the federal agents would be best able to value what the money market was for the whole country, and therefore be thoroughly justified in saying the rate of return ought to be 12 percent rather than 6 percent.

[36] MR. FRIED: Well, rate of return seems to us to be different from depreciation.

QUESTION: It is more a local matter, do you think?

MR. FRIED: Well, it may be more local. Of course, it is subject to federal constitutional limitations, which—these other elements are not, at least not directly, but the other aspect of depreciation is depreciation is a fact in the world. It is not really a—it is not really a normative judgment at all.

When you decide whether you are going to have businesses subsidizing residences, that is a political judgment and one which we can understand the state commissioners would like to reserve for themselves, but how quickly something depreciates, and what you do about misestimates of depreciation, which is what remaining life versus whole life is all about, that is about facts in the world.

QUESTION: But even with respect to the accountants—

QUESTION: You don't think the accountants disagree about these things?

QUESTION: We are saying the same thing.

MR. FRIED: I am sorry, Justice—

QUESTION: I think Justice Stevens and I both [37] wanted to ask you, don't respected accountants disagree about how depreciation should be handled?

MR. FRIED: Well, indeed they do, Justice Rehnquist. But the question is that in the face of such a disagreement, is the FCC out of bounds or is it not in fact exercising the authority given to it in Section 220

to resolve that question and to resolve that question on a record which shows that the previous rule had resulted in something like $20 billion of unrecovered phantom assets as the result of too slow depreciation and an unwillingness or an inability under the old whole life formulas to recapture when you have made an initial mistake?

So it was a response, to be sure. Accountants will differ. They are probably like lawyers. They will differ about almost anything. But the question is whether the determination here was a reasonable one—

QUESTION: Well, the question isn't so much whether the determination here was a reasonable one, but whether the concept or element of depreciation is so dramatically different from the other elements of rate as you have made them out to be, that those are kind of political judgmental questions, and this is just purely a question of historical fact.

I don't think it is quite that simple.

[38] MR FRIED: I perhaps am oversimplifying somewhat, but I think depreciation is in the end—accountants would agree to this, that depreciation in the end is an attempt to reflect year by year a fact about the world. And they may differ about the best way to do that. When you are designing rates, nobody disagrees that that is a political judgment about who ought to be paying what and who ought to be subsidizing who.

So, it is in that respect that I think the two are rather different.

QUESTION: But certainly rate base is equally factual, isn't it, the capital investment and plant at any given time?

MR. FRIED: Well, in respect to rate base—

QUESTION: It is the other side of the coin from depreciation.

MR. FRIED: Rate base is a matter of valuation, and there—at least it starts out with the initial valuation of the asset, and there I believe 213 does speak directly to that, and as I understand it, the Commission here has not sought in any way to intervene on the subject of the initial valuation of these assets. It has made no attempt to say anything on that subject.

I think one of the positions which needs to be—which is a matter of concern is the question of the [39] FCC's having changed its position, and one is used to regulatory commissions sometimes turning on a dime. That is not an unfamiliar process.

But here I think that turnaround should not be exaggerated, because in fact the way was prepared because of the assumption, because of the assumption that the states would go along with what the FCC had determined, and the subsequent experience which is raised for you by the Ohio case which you are holding, I suppose, for the result in this case, as shown in the Ohio case and in many other cases where for the first time there was confrontation.

Now, I think that Judge Tuttle in the Fourth Circuit explained very well why there is this confrontation. There is in depreciation—I thank the Court.

CHIEF JUSTICE BURGER: Mr. Boudin.

ORAL ARGUMENT OF MICHAEL BOUDIN, ESQ.
ON BEHALF OF AT&T AND THE
BELL SYSTEM OPERATING COMPANIES

MR. BOUDIN: Mr. Chief Justice, and may it please the Court, the position of the telephone industry in this case is that the FCC's preemption order is correct and should be sustained.

I want to make clear at the outset what the [40] facilities are, what the FCC has and is doing, and what the states are asking to do in this case.

The facilities in question are telephone poles, lines, and switching systems along with the buildings that house them that are used jointly in interstate and intrastate communication. The FCC, as it has for many years, is determining the percentages, the useful lives, the depreciation formulas so that in the end you say of a telephone pole, this pole will last five years, it must be depreciated at 20 percent a year.

And what the states are saying is that they are entitled with respect to this same telephone pole to say, no, it is going to last ten years, depreciated at 10 percent a year. It is exactly the case of two hands on the steering wheel. The Chief Justice was absolutely right.

And this is not a remarkable reversal of past practice. The FCC has had rules relating to depreciation since its foundation. It has been prescribing depreciation for about 95 percent of the telephone plant in the United States since the late forties and early fifties, and the states have in fact with very rare and unimportant exceptions followed

those depreciation rates in intrastate proceedings because you are talking about depreciation of exactly the same facility.

[41] You cannot in fact have accurate depreciation for the telephone pole, mathematically cannot do it except by one in a billion chance. You have two different regimes of depreciation, two different formulas for the same physical facilities.

GTE actually put in a mathematical illustration demonstrating it which is in the joint appendix, but the practical consequences are what are of importance to us.

QUESTION: May I ask, Mr. Boudin, must they also have the same evaluation on the capital investment?

MR. BOUDIN: The valuation is a red herring. There has been no dispute about valuation. Its original cost is what is used since Hope Natural Gas. That 213(h), which was not addressed—

QUESTION: Isn't it original cost less depreciation?

MR. BOUDIN: Original cost less depreciation is the rate base, but the valuation is the original cost less the accumulated depreciation.

QUESTION: Does it mean, then, that the Commission rule has the effect of determining what the rate base will be for all the—

MR. BOUDIN: No, because you have to make a large number of different determinations with respect to rate base, some of which are historical, some of which [42] are legal or public policy. It does not. This is solely the determination as to the length of time and the spreading out of that cost, whatever it may be.

QUESTION: Well, confining it to the telephone pole for a moment, must the remaining cost, the remaining value of the telephone pole be the same for both federal and state purposes in determining rate base?

MR. BOUDIN: It will virtually always—in fact there is very little disagreement.

QUESTION: Well, but must it be the same under the commission—

MR. BOUDIN: You mean if the states try to set a different value?

QUESTION: Say they wanted to use their old-fashioned method of depreciation for purposes of measuring original cost. Could they do so?

MR. BOUDIN: They cannot use an old-fashioned method of depreciation. They may or may not be able to use a different method of valuation.

QUESTION: Under the regulations as they exist today?

MR. BOUDIN: Yes.

QUESTION: Could the commission forbid them from using a different original cost measure—

MR. BOUDIN: It would be a significantly more [43] difficult case, because it would take you back to the distinction between valuation and depreciation. The FCC has clear statutory authority with respect to depreciation. On valuation, you can make a great deal of argument. I want to—

QUESTION: On valuation of a telephone pole, I am wondering if you can have one person driving and another one working the—

MR. BOUDIN: Well, that would be—that is another case, and it is a harder case for the telephone company and the commission.

Let me make that clear by turning back to the argument on the legal issue in the case, and on the statutory language that Congress enacted, because we think Section 220 is the key to this case. It solves this case without deciding more difficult cases later on, and the result in this case is very clear.

Congress in Section 220 of the Act told the commission that on this issue, depreciation and accounting, the FCC shall determine the depreciation for subject carriers. The subject carriers shall not use any other method of depreciation, and the FCC shall consider the views and recommendations of the state, views and recommendations, but not the binding veto.

That statutory language was taken from Section [44] 20(5) of the Interstate Commerce Act, because the Interstate Commerce Commission had the same power.

QUESTION: Mr. Boudin, why did the Court of Appeals shy away from reliance on this section?

MR. BOUDIN: Because the other ground, agency preemption, was so clearly established in the Fourth Circuit by the two North Carolina cases that there was nothing new to decide as long as they didn't bother with the new statute.

It is nevertheless the clearest ground for affirmance and it is the narrowest ground, and that is why I am arguing it.

That statutory language, Section 220(b), was taken virtually verbatim from Section 220(5) of the Interstate Commerce Act enacted in 1920. The Interstate Commerce Commission has interpreted

that language in 118 ICC in 1926, its major decision on depreciation, as establishng that ICC depreciation rates would preempt when the ICC adopted them.

That information was no secret to Congress when it came to frame the Communications Act because the states bitterly complained of it. Nevertheless, Congress reenacted that identical language which the ICC had interpreted as being automatically preemptive if and when the depreciation rates were determined.

[45] Third, Congress refused a specific state request to enact a reservation which would have specifically entitled the states to prescribe their own depreciation rates for intrastate ratemaking purposes. Congress considered the proposal.

It listened to a lot of testimony on it, including explanations that it would be a deviation from the existing law, and the sponsors of that amendment, the House report, Congressman Rayburn, said that it would be a change in the existing law if that reservation were adopted, and Congress refused to adopt it.

The Pacific Gas and Electric case was mentioned earlier. Justice White at Page 220 of that case pointed out that it is an improper construction of a federal statute to read it as embodying a statement which Congress considered and specifically refused to enact, and that is exactly what the states are requesting here. They are asking you to read Section 220 as if Congress passed a provision about which it considered specifically and refused to enact it.

QUESTION: So your argument, of course, is that the statute does the preempting, and it is not a case of agency preemption. The agency couldn't do anything else but.

MR. BOUDIN: Well, the agency is entitled under [46] 220 to cede the authority to the state if it wishes to, so it could do something else, but only after an—

QUESTION: Why is it entitled to do so?

MR. BOUDIN: The section provides, 220(h), that it can cede its 220 powers to the states if it wishes to.

QUESTION: And did it for a long time or not?

MR. BOUDIN: It prescribed the depreciation itself, but it did so after consultation, the three-way meeting with the states. All that the FCC is doing here is insisting on the continuation of a practice that has been going on for 30 years. Now that the states have decided on this particular method of calculating depreciation, they no longer want to follow the FCC's lead.

And I say again, to close, this is a two hands on the steering wheel case on this single issue. It involves only depreciation. There are good economic arguments for having separate rates of return. There is much less statutory authority, certainly no legislative history suggesting that the FCC could regulate it, and it is simply an issue that does not get reached if the Court agrees that Section 220 resolves this case.

And I might add that Section 220 also solves the Section 2(b)(1) argument without having to parse [47] 2(b)(1) for 25 other situations, because I ask the Court

to consider this. If Congress did, as we think the legislative history clearly shows, decide in 1934 that it should continue to allow the federal agency to determine this common issue of depreciation, then the one thing you know is that some general language elsewhere in the statute can't be read to contradict that specific legislative intent.

Most preemption cases are quite difficult. They involve guesses as to what Congess would have done if it had thought about the issue. They involve occupation of the field conjectures, possibilities of frustration. This is not such a case. This is a case where we know that Congress thought about this precise issue, and on depreciation, as on one or two other issues in the Act, it decided in favor of federal authority.

QUESTION: Well, what about—what was your response to—his response to 152(b), Section 152(b), where the commission is denied jurisdiction with respect to charges and so on with respect to intrastate communication?

MR. BOUDIN: The answer to that is twofold. First, that if you accept the reading of 220, you do not even reach the question of how 2(b) might be parsed in general, because this issue has been resolved, but the [48] second answer is, if you turn to the language—

QUESTION: What if you—if you read (b), you don't even get to 220.

MR. BOUDIN: No, it is circular. It can go around either way. If you assume that Congress had a specific intent on the subject of depreciation and resolved that in a particular way, then the specific resolution of that issue prevails over any general language.

QUESTION: Because 220 deals specifically with depreciation?

MR. BOUDIN: Exactly, and also involves the preemptive—

QUESTION: I thought charges included depreciation.

MR. BOUDIN: The term "charges" in Section 2(b)(1) in our contention is a reference to rates charged to customers. There is linguistic evidence to that effect in the Act. Mr. Justice White, just to underscore that point, because I don't want to trespass further on the Court's time, we know what Congress was worried about when it enacted Section 2(b) because the legislative history addresses that, to.

It was not concerned with depreciation charges. It was concerned with the Shrevport doctrine [49] and rates charged to customers.

I thank the Court.

CHIEF JUSTICE BURGER: Do you have anything further, Mr. Malone?

MR. MALONE: Yes, Your Honor.

CHIEF JUSTICE BURGER: You have five minutes remaining.

ORAL ARGUMENT OF LAWRENCE G. MALONE, ESQ., ON BEHALF OF THE APPELLANT AND THE PETITIONER—REBUTTAL

MS. MAGUIGAN: Thank you very much.

Your Honor, the telephone industry has argued that the Congress merely reenacted Section 25 of the Interstate Commerce Act which the ICC had read as

allowing preemption although no court had, and rejected a number of arguments by the states and provisions which would have preserved the status quo, which at the time was the state's regulation of depreciation in accounting matters.

What the telephone industry has ignored is that Congress indeed did provide, and the legislative history clearly supports this, a number of provisions in response to the state's request that its authority be clarified. Sections 220(j), 152(b), and 213(h) were all additions to the Communications Act from the Interstate Commerce Act clearly designed to protect the states.

[50] With respect to the history, what has gone on for the last 50 years, the Solicitor General suggests that the three-way meetings have led to the FCC setting rates which the states have followed. The facts are otherwise.

We have in our briefs references to state decisions which were published in the fifties, sixties, seventies, and eighties which deviated from the FCC practices. We have a letter which is appended to the—

QUESTION: Are we supposed to decide here which one of you is right about the history, what was the status quo at the time?

MR. MALONE: Your Honor, the decisions—it is documented in our briefs. There is a letter from the FCC appended to the Louisiana brief which says to the state of New York, we know you have deviated from our rates and you have every right to because you have jurisdiction over these matters. It is in black and white. It is signed by the secretary of the FCC. It is appended to the Louisiana reply brief.

At Page 45 of the California petition, the appendix to the California petition, the FCC says unequivocally, the states have the right, they have the right to deviate. They have done so for 40 years. We have no right to tell them to do otherwise. I think the [51] history is very clear.

Justices Rehnquist and Stevens asked, is it not true that accountants have differed over depreciation and accounting. The answer is clearly yes, and so has the FCC and the FCC admits that at Page 23 of the joint appendix, where it says there is no right or wrong to depreciation, and the suggestion by the telephone industry here today that unless there is one regulator setting depreciation charges, we won't have accurate depreciation is belied not only by the FCC's statement at Page 23 of the joint appendix, which it made before attempting to preempt, but also the fact that there are a number of telephone companies who are not here today.

Part of the Bell System, Pacific Telephone and Telegraph, they are not supporting this preemption case, because in those states the FCC is setting rates faster—

QUESTION: Didn't Mr. Boudin say to us that all of the telephone companies were in support of this position?

MR. MALONE: They are absolutely are not in support of it. Pacific Telephone and Telegraph is not in support of the FCC's position.

QUESTION: That is something else we have got to resolve?

MR. MALONE: Your Honor, I think by just [52] checking the service list to the telephone company's brief, we will see that there are many, many telephone companies—the telephone companies who are getting rates higher from the states are not supporting preemption because there is one issue here from the telephone company's point of view. It is not accurate depreciation rates, it is money.

QUESTION: Then when you refer to the telephone industry, it isn't the entire industry.

MR. MALONE: Well, as far as Mr. Boudin is not representing the telephone industry, that is correct. He is representing the telephone companies which have supported the FCC.

QUESTION: Well, are there any who have not appeared here—

MR. MALONE: Oh, yes.

QUESTION: —who are supportive of your position?

MR. MALONE: Who are supporting the—

QUESTION: Affirmatively supporting your position?

MR. MALONE: Any telephone companies supporting our position affirmatively? No, there are not, Your Honor. That would be heresy. I don't think that they would go quite that far.

[53] (General laughter.)

MR. MALONE: Your Honor, with respect to valuation, there is no question that the cannot tell the states how to accrue specific depreciation charges without telling them the valuation of the assets that

are at issue. They seem to concede indirectly that that would be a very difficult case to take over valuation, but yet that is precisely what they are trying to do, and I would refer you to Page 35 of the FCC's brief.

QUESTION: Why would it be such a difficult case? Why would it be such a difficult case? 220(a) specifically says the Commission may prescribe forms of any and all accounts. Why can't they just do that literally?

MR. MALONE: Because 213(h), the valuation statute, says that the states have the right to set valuation.

Your Honor, with respect to the final point, which is whether there are in fact two hands on the wheel, and whether our position is the same as that which has been rejected by the lower courts with respect to Section 152(b) in the past, it is clearly not the same position. You can uphold this in this case without touching those opinions at all, because we are dealing here with joint costs which have been separated and are [54] in the jurisdiction of each, the state and the federal jurisdictions.

Thank you very much.

CHIEF JUSTICE BURGER: Thank you, gentlemen.

The case is submitted.

(Whereupon, at 2:02 o'clock p.m., the case in the above-entitled matter was submitted.)

CERTIFICATION

Alderson Reporting Company, Inc., hereby certifies that the attached pages represents an accurate transcription of electronic sound recording of the oral argument before the Supreme Court of The United States in the Matter of:

#84-871—LOUISIANA PUBLIC SERVICE COMMISSION, Appellant v. FEDERAL COMMUNICATIONS COMMISSION, ET AL;

#84-889—CALIFORNIA AND PUBLIC UTILITIES COMMISSION OF CALIFORNIA, ET AL., Petitioners v. FEDERAL COMMUNICATIONS COMMISSION AND UNITED STATES;

#84-1054—PUBLIC UTILITIES COMMISSION OF OHIO, ET AL., Petitioners v. FEDERAL COMMUNICATIONS COMMISSION, ET AL.; and

#84-1069—FLORIDA PUBLIC SERVICE COMMISSION, Petitioner v. FEDERAL COMMUNICATIONS COMMISSION, ET AL.

and that these attached pages constitutes the original transcript of the proceedings for the records of the court.

By /s/ PAUL A. RICHARDSON
(REPORTER)

STATUTES

47 U.S.C. §151

47 U.S.C. §151:

Purposes of chapter; Federal Communications Commission created

For the purpose of regulating interstate and foreign commerce in communication by wire and radio so as to make available, so far as possible, to all the people of the United States a rapid, efficient, Nation-wide, and world-wide wire and radio communication service with adequate facilities at reasonable charges, for the purpose of the national defense, for the purpose of promoting safety of life and property through the use of wire and radio communication, and for the purpose of securing a more effective execution of this policy by centralizing authority heretofore granted by law to several agencies and by granting additional authority with respect to interstate and foreign commerce in wire and radio communication, there is created a commission to be known as the "Federal Communications Commission", which shall be constituted as hereinafter provided, and which shall execute and enforce the provisions of this chapter.

(June 19, 1934, c. 652, Title I, §1, 48 Stat. 1064; May 20, 1937, c. 229, §1, 50 Stat. 189.)

47 U.S.C. §152

47 U.S.C. §152:

Application of chapter

(a) Applicability of interstate and foreign communications or transmissions of energy originating in or received within the United States by wire or radio; Canal Zone exception; cable services

The provisions of this chapter shall apply to all interstate and foreign communication by wire or radio and all interstate and foreign transmission of energy by radio, which originates and/or is received within the United States, and to all persons engaged within the United States in such communication or such transmission of energy by radio, and to the licensing and regulating of all radio stations as hereinafter provided; but it shall not apply to persons engaged in wire or radio communication or transmission in the Canal Zone, or to wire or radio communication or transmission wholly within the Canal Zone. The provisions of this chapter shall apply with respect to cable service, to all persons engaged within the United States in providing such service, and to the facilities of cable operators which relate to such service, as provided in subchapter V-A of this chapter.

(b) Exceptions to Federal Communications Commission jurisdiction

Except as provided in sections 223 through 227 of this title, inclusive, and subject to the provisions of section 301 of this title and subchapter V-A of this chapter, nothing in this chapter shall be construed to apply or to give the Commission jurisdiction with respect to (1) charges, classifications, practices, services, facilities, or regulations for or in connection with intrastate communication service by wire or radio of any carrier, or (2) any carrier engaged in interstate or foreign communication solely through physical connection with the facilities of another carrier not directly or indirectly controlling or controlled by, or under direct or indirect common control with such carrier, or (3) any carrier engaged in interstate or foreign communication solely through connection by radio, or by wire and radio, with facilities, located in an adjoining State or in Canada or Mexico (where they adjoin the State in which the carrier is doing business), of another carrier not directly or indirectly controlling or controlled by, or under direct or indirect common control with such carrier, or (4) any carrier to which clause (2) or clause (3) of this subsection would be applicable except for furnishing interstate mobile radio communication service or radio communication service to mobile stations on land vehicles in Canada or Mexico; except that sections 201 to 205 of this title shall, except as otherwise provided therein, apply to carriers described in clauses (2), (3), and (4) of this subsection.

(As amended Dec. 20, 1991, Pub.L. 102-243, §3(b), 105 Stat. 2401.)